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**Management of lenders' currency exposure in multicurrency financings:  
structural and documentational considerations.**

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INTRODUCTION

International commercial financing (1) continues to play an important role in the world economy despite the recent Third World debt crisis. (2) A noticeable development since the mid-1980s is an increase in multicurrency lending by U.S. banks, not only in regular credit facilities for U.S. based multinational corporations, but also in some recently structured multi-billion dollar acquisition financings. The expansion of offshore operations by major businesses and the growing importance of major foreign currencies (3) relative to U.S. dollars in the world economy have increased the need for foreign currencies. (4) In addition, the creation of friendly foreign exchange regulations and the resulting increase in the convertibility of major currencies in many industrial countries have facilitated multicurrency lending.

The growth of multicurrency lending is also due to the competitiveness of international syndicated loan markets. Today, banks increasingly must resort to new financing concepts and innovative banking services to gain a competitive edge, (5) because, under intense competition, they are often compelled to charge "dangerously narrow" margins on loans, (6) leaving little room for competitive pricing. "One stop shopping," a synonym for comprehensive banking service, now includes banks' multicurrency lending capacities. (7) A growing number of U.S. banks have developed a multicurrency financing practice, an area previously dominated by only a few money-center banks.

The development of a mature international financial market offering various financing products has also contributed to the increase in multicurrency loans. Interest rate and currency swaps, for instance, have created opportunities to profit from interest rate differentials between various currencies. This has led sophisticated borrowers and lenders increasingly to resort to financing products in multicurrencies. (8) The international financial market also makes it possible for lenders without offshore branches or foreign currency deposits to readily obtain different currencies to meet their funding needs. (9)

Although multicurrency lending has led to new business opportunities, banks now face corresponding new risks, the most troubling of which is currency risk. European banks appear much more comfortable than their U.S. counterparts with multicurrency lending. In fact, many U.S. banks, especially regional banks with newly established international banking practices, have not yet developed a set of workable guidelines to minimize the risks associated with multicurrency lending. To help lenders deal with currency risks, the first part of this article analyzes major risk factors to multicurrency lenders and the legal, policy, and operational considerations underlying hedging and risk allocation. The next section discusses financing structures designed to minimize lenders' currency exposure. Finally, the article highlights various documentational considerations related to multicurrency loans and reviews provisions for protecting lenders that are commonly found in multicurrency loan agreements.

LENDERS' CURRENCY RISKS IN MULTICURRENCY FINANCING

Generally, currency risk refers to the risk of loss caused by exchange controls or regulations imposed by domestic or foreign governments, (10) by exchange rate fluctuations, or by currency devaluation. Under the current floating system, (11) which was introduced following the dollar devaluation in December 1971, each currency moves freely relative to other currencies, driven by a "constantly shifting

blend of economic, political and psychological causes." (12) Although it had been hoped that exchange rates would fluctuate within narrow ranges, "[u]nfortunately, as time has gone on, the swings in currency values have become extreme, with currencies rising and falling 20 percent or more in a year." (13) According to the 1989 World Bank Annual Report, "[i]n 1987, close to \$70 billion of the nominal increase of total developing-country debt was accounted for by the devaluation of the U.S. dollar against the major currencies." (14) Such exchange rate fluctuations and potential governmental foreign exchange restrictions directly impact the value of a loan currency and a borrower's repayment ability. This section is intended to assist multicurrency lenders in understanding and assessing their currency risks in order to determine their negotiating positions with respect to the documentation and structural issues associated with a multicurrency loan.

A lender's currency risk in a multicurrency transaction normally includes the following : (i) the lender's exposure directly relating to the foreign currency (15) loan; (ii) the borrower's exposure as a result of its foreign currency borrowing, business operations, and assets and equity positions; and (iii) the risks of unfavorable foreign exchange regulations. The borrower's currency risk is relevant to the lender's interest because the borrower's exposure could translate into the lender's loss. This is often the case in highly leveraged transactions, where such currency exposure impairs the borrower's ability to repay the loan.

#### Lender's Direct Exposure

A lender's direct exposure primarily includes the risk of net cash loss, overexposure, and third party liabilities that the lender incurs by lending in a foreign currency. (16) A lender may incur a net cash loss if, as a result of exchange rate variations, the dollar equivalent of foreign currency repayments decreases relative to the dollar equivalent when the loan was made or liabilities were incurred, and the lender must convert the borrower's foreign currency repayments into dollars. This exposure can be avoided with respect to the principal amount of the loan if, as is normally the case, the lender funds its foreign currency lendings by incurring matching foreign currency liabilities through match-funding or taking foreign currency deposits. In such cases, the borrower's foreign currency repayments would offset the lender's matching foreign currency liabilities irrespective of their dollar value. Thus, unless the borrower defaults on its debt, adverse exchange rate swings will not affect the lender's net position, because the lender will not need to make conversions. However, the lender's fee and interest income in a foreign currency may remain exposed to risks similar to those outlined above because the lender normally finds it difficult to specifically hedge such exposure. Thus, the lender could experience a reduced profit margin, or even a loss, if the exchange rate moves unfavorably. (17)

A lender may also incur a net cash loss if its funding cost increases due to special foreign exchange taxes or reserve requirements, and the lender is unable either to recover the cost from the borrower or to terminate its lending commitment. (18) In addition, currency movements may result in an unexpected increase in the funding cost. For instance, the movement of exchange rates in the currency market could increase the interest rate for a particular currency in the credit market, thereby resulting in a loss to a lender of an unhedged fixed-rate multicurrency term loan. (19)

When a borrower is unable to repay its foreign currency loan, a lender may incur a loss as a result of exchange rate fluctuations, in addition to the customary and predictable credit loss that it incurs. Lenders commonly meet their large lending commitments and hedge their currency risks by entering into swaps, forward contracts, or other arrangements, including match-funding. They thereby commit to third parties to deliver a predetermined amount of foreign currency, often deliverable at the time when the payment under the loan agreement is due. Upon the borrower's default, the lender may be forced to buy the foreign currency needed to pay its own matching liabilities at an unfavorable market rate. However, the lender may choose to "roll over" such foreign currency liabilities by entering a currency swap or other arrangement that allows the lender to receive the required foreign currency, or discharge its foreign currency liabilities currently due, in exchange for new foreign currency obligations due at a future date. Under this scenario, the lender

will incur a loss equal to its swap cost. When the lender eventually liquidates its position, a loss also may result if the effective conversion rate is unfavorable.

When a borrower delays in repaying its loan, the lender may incur a loss exceeding its customary credit exposure if the loan currency depreciates or is devalued while the loans are due and unpaid. This occurs because the depreciated or devalued foreign currency loan assets do not have matching foreign currency liabilities when the payments are eventually made. If the lender has third party liabilities and chooses to "roll them over" by entering a swap, the lender will incur a loss to the extent that such swap cost is neither fully compensated by the borrower's payment of interest at a post-default rate nor otherwise recoverable from the borrower. (20)

A lender's currency risk is also reflected in increases in its credit exposure during the life of a foreign currency loan, even though the outstanding amount of the loan remains unchanged. As a result of exchange rate fluctuations, the dollar equivalent of the total outstanding foreign currency loan may, at any given time, substantially increase relative either to the lender's commitment or to the collateral denominated in a currency other than the loan currency. Alternatively, the dollar equivalent of the collateral may significantly decrease relative either to the lender's commitment or to the amount of the outstanding loans denominated in different currencies. If the borrower has significant net asset positions overseas and the assets and loans are denominated in different currencies, the lender is especially vulnerable to such risk. (21) Depending on the lender's accounting and credit approval practices, the resulting variations in the value of the collateral and the outstanding loans may cause the lender's exposure, at any given time, to exceed the limit established by its credit approval. Such increased exposure is more than a theoretical or accounting problem. It could increase difficulties for loan syndication because the loan would appear to be undersecured. Furthermore, if the borrower becomes insolvent, or if for any other reason the loan must immediately be repaid or liquidated, the increased exposure in the book would precisely reflect the lender's actual loss.

#### Borrower's Exposure

Foreign currency liabilities under a loan agreement represent a direct exposure to the borrower that could substantially increase the borrower's indebtedness and could impair its ability to repay the loan unless properly hedged. For instance, if the borrower's assets or major cash flow are not denominated in the loan currency, the borrower may have to purchase the loan currency in the open market in order to repay the loan. This is often the case where the loan is made in a foreign currency solely for the purpose of taking advantage of the spread between the interest rates applicable to different currencies. In such a case, unless the borrower properly hedges its currency risks, the exchange rate effective at the time the loan matures or is accelerated would directly affect the borrower's repayment ability.

Foreign exchange exposure may be inherent in the borrower's ordinary course of business and therefore may directly impact the borrower's earnings and cash flow. Generally, a borrower with significant international business is particularly vulnerable to currency risks. Without an effective hedge, "[a] 10 percent rise or fall in the dollar could wipe out a whole year's profits overnight." (22)

For instance, if the borrower depends on imported raw materials, or mainly produces for export or otherwise competes with imported products, it is likely to be affected by exchange rate movements and therefore has an inherent currency exposure. Similarly, a borrower that obtains supplies from overseas, or otherwise has significant production cost components incurred in currencies other than the currency of its sales, is vulnerable to exchange rate swings. In these cases, the borrower may not realize its projected profit margins even though the business itself remains healthy by other standards. (23) If the borrower's cash flow is considered a major source of repayment, the borrower's currency risk in its ordinary course of business should be carefully analyzed because such risk may adversely affect the borrower's cash flow, and consequently affect its repayment ability.

The borrower may also have an exposure as a result of changes in its equity position and in the value of its fixed assets caused by exchange

rate swings, if all or a substantial portion of the borrower's assets are located overseas. If the loan collateral primarily consists of capital stock, or fixed or other assets located overseas, or if the lender otherwise expects to be paid out of the borrower's foreign asset sales, the lender may realize less than the projected collateral value if the exchange rate becomes unfavorable. This will occur if the value of the foreign currency, obtained through the sale of the borrower's foreign assets or collateral, has decreased in value relative to the repayment currency. The lender will then, upon exchange of the liquidated collateral into the repayment currency, receive less than it would have if the exchange rate had remained stable, or had moved in a way that the repayment currency decreased in value relative to the currency in which the collateral was held. (24)

Although a lender with bargaining leverage may shift the entire currency risk to the borrower by a variety of lending mechanisms, (25) it is important to note that shifting the currency risk to the borrower is not always the best approach. Because the lender is more experienced than the borrower in foreign currency transactions, and normally has a stronger credit standing in international capital markets, it may be less expensive for the lender to assume the currency risks than the borrower. The lender's risk assumption can lead to substantial savings for the borrower and thereby enhance the lender's competitiveness. Furthermore, as noted earlier, a borrower's exposure might impair its ability to repay a loan which, unless properly dealt with, can be translated into a lender's loss. Thus, a structure requiring the borrower to bear the currency risk should be accompanied by additional provisions or mechanisms to ensure that the borrower will properly hedge its currency risk, unless the borrower's credit standing and other factors justify a different approach. (26)

#### Foreign Exchange Control and Regulations

Foreign exchange controls imposed by either domestic or foreign governments may pose special risks to lenders. (27) Exchange controls directly impacting lenders' interests include the following: (1) currency devaluation; (28) (2) overseas remittance restrictions on foreign exchange; (3) mandatory sale of foreign exchange to the state; (4) quota systems; (5) licensing requirements; (6) special taxes on the outflow of foreign exchange other than the regular withholding tax on interest; and (7) officially imposed exchange rates that are inconsistent with the market, or so called "multicurrency practices." (29) The impact of these controls on lenders' interests could include the transaction being declared illegal, the forfeiture of the loan proceeds, and substantial delays in receiving repayments, to net cash losses due to the taxes, devaluations, artificially imposed dual exchange rates, or other governmental acts that might adversely affect the value of the loan currency. A lender's risk of loss also varies depending on the type of transaction. For instance, capital flow tends to be more extensively regulated than current accounts. (30) As a result, lenders who expect to be paid out of the sales of the borrower's assets located in a foreign country are likely to experience greater exchange regulatory hurdles than those who look to a foreign borrower's cash flow for the repayments.

Foreign exchange regulations may also affect the enforceability of the loan documents, not only in the forums of the regulating state, but also in a lender's home country or a third country. For instance, a violation of the exchange regulations applicable in the borrower's home country could render the loan agreement unenforceable in courts of any state that is a party to the International Monetary Fund (IMF). (31)

#### STRUCTURE OF MULTICURRENCY SYNDICATED FINANCING

The selection of an appropriate lending structure could effectively protect lenders against currency risk. While lenders are generally willing to adjust their lending structure to accommodate tax and other special needs or considerations of the borrower, their own currency exposure has rarely prompted them to make significant changes in lending structures. In fact, most multicurrency syndicated financings are structured in the same way as a domestic multi-bank financing. This is due in part to the lenders' reluctance to create new financing structures that might not be acceptable in the highly standardized syndication market. Although traditional financing structures often may work for multicurrency lendings, there are cases where the lenders' exposure and multicurrency related issues could not be adequately addressed without significant adjustments in the

financing structure. In such cases, alternative structures that provide greater protection against currency risks should be seriously considered.

This section introduces a multi-bank lending structure that may effectively protect lenders from currency risk without shifting the currency risk to the borrower. Under this structure, various currency facilities are nonratably allocated among the lenders on the bases of their currency exposure and their respective abilities to deal with the currency risk. Because lenders located in different countries have different functional or domestic currencies, one lender's exposure as a result of a foreign currency loan may not be a risk to a lender who deals with the same currency as its functional or domestic currency. Furthermore, some lenders, such as money-center banks, are in a much better position to deal with currency risk than other lenders because of their experience, financial strength, access to foreign lending offices, and other factors. Therefore, in a syndicated multicurrency facility, a viable approach to currency risk problems is to have some lenders lend in certain currencies and other lenders lend in other currencies. (32)

This lending structure is often dismissed as indistinguishable from separate, parallel loans in different currencies, each with different lenders. For a borrower, major drawbacks of parallel loans include increased transaction costs, borrowing costs, administrative burdens because of prolonged negotiations with numerous lenders on various terms, and reductions in the economy of scale due to the smaller size of each separate loan. With respect to lenders, parallel loans give rise to serious intercreditor problems in the area of default and acceleration. For instance, loan agreements are likely to have different financial covenants and different default provisions. Even if the default provisions are similar, the lenders might not follow similar practices in administering the loans and enforcing the provisions of the loan agreements. As a result, one lender, who may be insignificant, would have the ability to force upon the other lenders, default and acceleration through cross-default or cross-acceleration provisions. The allocation of collateral in the event of the borrower's insolvency also may be a problem. In many multicurrency financings, the collateral is located in more than one country and subject to different bankruptcy and insolvency laws. Without the benefit of a payment sharing clause, common in syndicated loan agreements or similar intercreditor arrangements, a lender in a foreign country with easy access to certain foreign collateral could obtain payment or liquidation preferences at the expense of the other lenders, as permitted under some foreign insolvency laws.

The lending structure proposed in this article is materially different from parallel loans. Unlike parallel loans, this lending structure allows the borrower to receive the benefits of traditional syndicated financing structures, including "one stop shopping" and dealing with one or a few lead lenders instead of numerous lenders under variable terms. It also gives the lenders a forum and opportunity to deal with intercreditor problems such as payment sharing, acceleration of loan maturities, enforcement of security interests and allocation of the collateral proceeds. To the extent an agreement can be reached, the lenders would be able to create a framework within which critical issues such as default and acceleration can be addressed uniformly and centrally, making it difficult for one or two creditors holding insignificant loans to cause across-the-board default and acceleration. This lending structure might also facilitate syndication because it allows the lenders to sell loan assets in one currency, instead of in a bundle of several currencies as in traditional syndication structures. Furthermore, with many lenders ratably sharing under traditional syndication structures, each lender may have only a small slice in an otherwise reasonably sizeable foreign currency facility, which could make it difficult for the lender to obtain funds at a reasonable cost through match-funding or other channels. (33) With a small number of selected lenders making loans in foreign currencies rather than an across-the-board pro rata sharing by all lenders, this structure can resolve the problem.

The lack of predetermined, invariable pro rata shares among lenders, as in the case of a traditional syndicated financing, is perceived as a major drawback of this multicurrency lending structure, even though non-ratable financing structures have become increasingly common in the credit market, particularly with the growth of the auction bid loans. Under

this multicurrency lending structure, lenders' pro rata shares on the closing date will change during the term of the loan agreement because the borrower may borrow or repay the loans denominated in some currencies without simultaneously borrowing or repaying under the facilities denominated in other currencies. (34) Borrowers also may reduce or terminate some foreign currency facilities without proportionately reducing or terminating others. As a result, each lender's share of the total outstanding loans and total commitments may change, and each lender's share in the total outstanding loans may also differ from its share in the total commitments. (35)

To make this structure marketable and operative, the loan documents must effectively address each of the problems arising from changes in lenders' pro rata shares. Specifically, lenders should identify the areas where changes in their relative shares may present an issue. Then they must analyze the impact that such changes would have on lenders' interests, and finally determine, in light of their relative interests and principles of fairness, which pro rata shares are to be used with respect to each specific matter. In some cases, lenders may consider introducing a mechanism to adjust their relative shares for limited purposes in order to achieve a fair and acceptable compromise.

In most transactions, invariable pro rata shares are designed to achieve parity among lenders, and therefore are an intercreditor issue with only negligible impact on borrowers' interests. (36) As a result, lenders have an interest in maintaining ratable shares only where intercreditor relationships are involved. Therefore, the issue of pro rata shares usually arises in areas of voting, fee sharing, payment sharing, and risk sharing upon a borrower's default, including allocation of collateral proceeds. Depending upon the complexity of a transaction, there could be other areas of special interest to lenders that require consideration.

Commonly, two ratios are referred to in determining lenders' relative interests with respect to any issue: commitment pro rata shares, determined on the basis of the lenders' shares in the total commitments; (37) and loan pro rata shares, determined on the basis of the lenders' shares in the aggregate outstanding loans at any given time. (38) A lender's commitment pro rata share often does not change (39) because the borrower cannot request frequent reductions or terminations of selected currency facilities. This is due to the fact that loan agreements normally provide that a commitment, once reduced or terminated, may not be increased or reestablished. A lender's loan pro rata share does change from time to time, and it more directly reflects the lender's material interest in the financing relative to the other lenders.

All solutions to pro rata share problems result from balancing lenders' interests in administrative efficiency and their interests in preserving their fair shares of control, profit and risk relative to other lenders. Generally, there is no reason why lenders could not use loan pro rata shares for all matters, especially in transactions that do not involve constant changes in lenders' relative shares in the loans and commitments, as in the case of a straight multicurrency term loan facility without working capital components. If lenders desire a relatively stable standard to facilitate loan administration, however, then they may follow this general rule: except for matters material to lenders' interests, which should be governed by loan pro rata shares, commitment pro rata shares apply to all matters.

Generally, changes in lenders' ratable shares should not present a serious voting problem in most multi-bank syndications. In these transactions, which normally consist of a large number of lenders, administrative power is placed largely with the lead lender, and each lender's voting power is not significant relative to any other lender. (4). In addition, the controlling power with respect to important matters, such as waiver of certain defaults by the borrower, always is vested with "requisite lenders," a term which usually refers to an interest representing fifty percent or more of the total facility. The issues that materially affect the lenders' interests--such as release of all or substantially all of the collateral, change of lenders' commitments, interest rates or maturity, and forgiveness of the obligations, etc.--are determined by the unanimous votes of all of the lenders. Most lenders' relative voting power would not be meaningfully affected, regardless of whether commitment pro rata shares or loan pro rata shares determine the

voting. As a result, lenders should not find it difficult to reach a compromise on voting issues. Generally, lenders may consider voting on the basis of their commitment pro rata shares until after the acceleration or the borrower's insolvency, in which case loan pro rata shares should apply. Loan pro rata shares should also govern voting with respect to certain matters material to lenders' interests such as declaration of default or acceleration.

In a syndication consisting of both term and revolving facilities, the interests of the fully funded term loan lenders and the interest of the revolving lenders with partly funded or unfunded commitments must be carefully balanced. For instance, the revolving lender with a large unfunded commitment may find it difficult to accept loan pro rata shares, resulting in fully funded term loan lenders deciding issues which may be of particular importance to the revolving lender's relative interest. Such a lender's interest could be prejudiced, for instance, if the loan pro rata shares are used to determine whether an event has occurred that gives rise to the lender's right to terminate the revolving commitment. The term loan lenders probably would like to see the revolving commitment in place even if the borrower is in financial difficulty, in order to meet the borrower's working capital needs and to preserve the borrower as a viable going concern. The revolving loan lender with a small outstanding amount, however, probably would like to see the revolving commitment terminate as soon as the borrower has financial problems in order to limit its losses. In such cases, a compromise can be reached by using commitment pro rata shares to determine issues with respect to working capital loans, such as voting the existence of certain matters that allow the lenders to suspend lending, and using loan pro rata shares to determine other matters.

Fee sharing is another area where the question of how to determine lenders' relative shares is important. Fees in syndicated loans generally include up-front fees, such as closing fees or commitment fees, which are paid on or prior to the closing date, and fees generated during the life of the facility, such as unused commitment fees. (41) Ordinarily, up-front fees should be divided on the basis of the lenders' commitment pro rata shares, (42) whereas the fees generated during the life of the facility, such as unused commitment fees, should be shared on the basis of the average unused amount--which is the difference between the commitment and the outstanding loan--with respect to each lender. The latter case reflects the application of loan pro rata shares.

Payments normally should be applied only to the loans denominated in the same currency in which the payment is made because the application of the borrower's payments in one currency to reduce loans in other currencies will give rise to currency risks and additional administrative burdens. Same currency repayments usually do not pose problems if the borrower is financially sound, even though the borrower's selective repayments may substantially change the lenders' loan pro rata shares. (43) When the borrower is in financial difficulty, however, a lender could become concerned if its relative share of the total outstanding loan increases, even if the net amount of the such lenders' total loans remains unchanged and is within its commitment. Furthermore, such selective repayments make it possible for the borrower to play favorites among the lenders by manipulating the borrowing and repayment currencies, and for some lenders to benefit at the expense of the others by influencing the borrower in selecting repayment or borrowing currencies. However, this problem may be resolved in part by creating a currency-based borrowing limit, limiting the borrower's right to borrow in specific currencies and requiring mandatory repayments when the borrower has excess cash. (44)

As a compromise between the need to protect the value of the borrower's repayments from conversion risk and the lenders' eagerness to get paid, payments may be applied ratably to the loans denominated in the currency in which the payment is made. These payments may be made until the borrower defaults or until a certain event leads the lenders to become more concerned with potential losses due to the borrower's credit risk than with losses due to currency risks. Thereafter, the repayments should be applied ratably to all of the outstanding loans. Alternatively, lenders that do not receive repayments may be granted a "put" right allowing them, within a limited period of time, to sell their participation to the lenders who have received the repayments. (45) This would be exercisable only if default or other triggering events occur, providing evidence of the borrower's

financial trouble.

Since collateral is pledged primarily to secure loans, the only equitable and acceptable allocation is to divide the proceeds of the collateral on the basis of the lenders' loan pro rata shares at the time of the liquidation. Lenders could consider, however, having multiple and separate collateral pools, each securing a particular currency subfacility. The collateral pools would be created in the currency in which the collateral is denominated, and/or the country in which the collateral is located, to ensure that the loan and the collateral securing the loan are in the same currency. Collateral pools would not only permit lenders to realize the maximum liquidation value by avoiding conversion of the collateral proceeds across currencies, but they would also allow the value of the collateral and the loan to depreciate or appreciate similarly, and therefore protect the lenders from excess credit exposure due to exchange rate swings.

To prevent drawbacks of parallel loans, the loan agreement should incorporate a cross-collateralization provision allowing the lenders secured by one collateral pool to take a second lien in each of the other pools and to have central control of default and acceleration. The proceeds of the collateral should be shared first by the lenders secured by the applicable collateral pool on the basis of their respective shares in the total outstanding loans secured thereby, and then by all the other lenders based on their respective shares in the total outstanding loans made by those lenders.

Lenders may also consider introducing an adjustment mechanism to ensure that their commitment pro rata shares are not substantially out of line with their loan pro rata shares. Most adjustment procedures are specific to the particular deal. The adjustment mechanisms are not recommended, however, because they normally impose additional administrative burdens on the lead bank and can give rise to structural complications in syndication.

The operation of one adjustment procedure can be illustrated by a simple two-lender financing consisting of a ten million dollar term loan and a ten million dollar equivalent revolving loan in sterling with Bank A holding seventy-five percent of the total facility, lending the entire term loan and half of the revolver, and Bank B holding twenty-five percent of the total facility, lending the other half of the revolver without the term loan. In this example, if the borrower repays the ten million dollar term loan from sales of its assets three months after the closing, the pro rata shares of the lenders would change for Bank A from the initial seventy-five percent to fifty percent and for Bank B from the initial twenty-five percent to fifty percent.

Although such changes of the lenders' relative shares do not increase any of the lenders' net loss assets, Bank B would have a strong interest in preserving the initial pro rata shares if the borrower does not have an A-1 credit rating and the repayment of the term loan as depleted the borrower's net worth. In such a case, the lenders' relative shares may be adjusted by increasing the revolver commitment of Bank A from the initial half to three-fourths and decreasing the revolver commitment for Bank B from the initial half to one-fourth. (46) Following the adjustment, the parties' pro rata shares would be the same as on the closing date, with Bank A holding seventy-five percent of the total facility and Bank B holding twenty-five percent. To minimize the administrative burden, adjustments should be made only if the loan pro rata shares are out of line with the commitment pro rata shares by a pre-agreed, material margin.

Pro rata shares may also be adjusted by requiring lenders to purchase participation from one another. This mechanism will not work if the lenders must purchase or sell a participation each time their pro rata shares have changed as a result of the borrower's borrowing or repayment under a particular currency subfacility. Not only does it give rise to administrative problems, it also increases lenders' currency exposure as a result of routine cross-currency payment sharing. (47) In most cases, if all other important matters relating to pro rata shares such as voting, fee sharing and payment sharing have been properly dealt with, the need for adjustment will arise only when the borrower defaults and the loan is liquidated. Only then is the issue of the lenders' shares significant, because the lenders then must have a benchmark to share the loss. As a result, the loan agreement could simply allow the pro rata shares to float



freely until the loans have been accelerated. Within a specified period following such acceleration, the lenders would be required to purchase participation from each other to bring pro rata shares back in line with their relative shares in the commitment. Although the lenders would still bear each other's credit risks, such risks can be minimized by carefully drafting the definition of "Eligible Lenders" to keep out lenders that are financially unsound. However, this repurchase obligation may affect the lenders' balance sheet and capital costs, and because of its complications, may also increase syndication difficulties. (48)

Finally, the lenders shall note that exchange rate swings may also impact the lenders' relative shares. Under this structure, each foreign currency loan or lending commitment has different lenders. The lenders' pro rata shares, therefore, as measured in any currency, may change from time to time as a result of the exchange rate fluctuations, even though all other factors impacting the lenders' relative shares do not come into play, as in the case of straight term loans with the same maturities but without prepayments. As a result, the loan agreement should identify the exchange rate to be used to determine the applicable pro rata shares. Because commitment pro rata shares apply only to matters not material to lenders' interests, the lenders may use the exchange rate effective on the closing date or on the date when the commitment pro rata shares were last determined, and should also allow the lenders to redetermine the rate in the event the rate has moved by a predetermined margin. On the other hand, because the loan pro rata shares apply to matters of importance to the lenders' interest, the exchange rate effective on the date of the determination should govern because such exchange rate should ensure greater accuracy.

#### DOCUMENTATIONAL CONSIDERATIONS OF MULTICURRENCY FINANCING: PROVISIONS DESIGNED TO MINIMIZE LENDERS' CURRENCY RISKS

To minimize a lender's currency exposure in a multicurrency lending, loan documents should accomplish three objectives. First, they should accurately reflect the risk-sharing as agreed between the lender and borrower. With respect to the risk which the lender has assumed, the cost of hedging or assuming such risk should be properly shifted to the borrower if such costs are not reflected in the loan pricing. Second, to the extent the financing structure permits, the loan documents should minimize the currency risks to both parties. Third, with respect to the currency risk shifted to, or assumed by the borrower, the loan documents should ensure that the lender be able to monitor the borrower's exposure and that the borrower properly hedges the risk. The loan documents should also contain provisions dealing with legal and operational issues commonly associated with multicurrency financings. This section analyzes special multicurrency provisions designed to accomplish these objectives and the related drafting issues. Whether a loan agreement should include any or all of the following provisions depends on the bargaining power of the parties and the lenders' special concerns and needs.

#### Definition of Exchange Rate and Concept of Currency Equivalent

In a multicurrency financing, exchange rate is sometimes defined in the loan documents, but often it is incorporated in the definition of "currency equivalent," a measurement designed to express in one currency rate value of any given amount of a different currency. (49) Exchange rates are used typically for two purposes: (1) to value a foreign currency loan on the funding date in order to determine the reduction of the lender's commitment in dollars; and (2) to value the borrower's repayment of the loans or other obligations where such repayments are made in a currency other than that in which such obligations were originally made due. This second function may materially impact lenders' interests, and therefore should be considered carefully when determining whether a given exchange rate definition is acceptable.

Exchange rate is normally defined by referring to the rates offered by money-center banks. (50) Most reference banks have at least three exchange rates applicable to the relationship of any two currencies: (1) the buying rate, which is the rate at which a given amount of currency may be purchased with another currency; (2) the selling rate, which normally refers to the rate at which a given amount of one currency may be sold for an amount of another currency; and (3) the average of the buying and selling rates. As foreign exchange traders "buy low and sell high" to

profit from the spread between their buying and selling rates, the selling rate offered by a money center bank, is always higher than its buying rate. (51) Accordingly, the loan documents should make clear which of these three rates apply in order to avoid confusion.

In practice, the selling rate--which is offered to the borrower and therefore is its buying rate--and the average buying and selling rate are typically used. The use of the selling rate has the advantage of ensuring that the value of a foreign currency loan, as expressed in a given currency, matches its market value; that is, the value one is able to acquire in the open market with such a foreign currency loan.

On the other hand, because of the spread between the selling and buying rates, the use of the average buying and selling rate creates a gap between a foreign currency loan's actual market value and its value determined under such rate, as expressed in a given currency. This gap could translate into a loss, or reduced profits, for a lender. Consider, for instance, a financing with a significant yen facility under which the borrower's yen payments are allocated among all of the lenders, including the dollar lenders, with the following clause in the loan agreement: "the amount of such loan to be prepaid shall be calculated using the arithmetic average of the buying rate and selling rate of the applicable currency as quoted as of 10:00 a.m. (New York time) on the date of the actual payment by the Agent." Under this definition, a dollar lender receiving a yen payment will be deemed to have its dollar loan reduced by an amount which is less than what the lender could receive by exchanging its yen payment for dollars on the open market. This is because the lender must buy dollars under the higher selling rate, which is offered to the lender and therefore is such lender's buying rate, rather than the relatively lower average buying and selling rate.

The use of average buying and selling rates may be less problematic if all of the lenders are large money-center banks that offer regular foreign currency trading. In that case, the average buying and selling rate is likely to result in a loss of the opportunity to make a profit rather than an actual loss, since part of the spread between the buying and selling rates actually reflects the banks' profit margin for foreign exchange trading. Small banks and other less significant players, like an insurance company or a pension fund buying a participation, however, should take into account this potential loss or reduction in profits.

Due to the volatility of the currency market and the likelihood that exchange rates may swing significantly within a short period of time, (52) when defining exchange rate, or when referring to an exchange rate, it is important to make absolutely clear the time of determination of the applicable exchange rate. Ambiguities are bound to give rise to disputes as to the applicable rate. For instance, an exchange rate that is defined only as the rate effective on the date of determination could be interpreted to mean many rates if the rate moves significantly during the trading hours for such date. Another common problem arises when payments are due, or their value is to be ascertained, on a nonbusiness day, and the exchange rate definition fails to make clear whether the applicable exchange rate is the one in effect before or after the nonbusiness day, when the rate is not available. Although loan agreements usually require that a payment due on a nonbusiness day be made on the previous or the following business day, such provisions do not necessarily make clear the value date of the borrower's repayments.

Consider the following scenario: a loan denominated in yen is due on a Saturday, the payment is to be made on the following Monday under the loan agreement, and the borrower is required or allowed to pay in dollars an amount equal to the "yen equivalent." In this case, the borrower and the lender are very likely to disagree as to whether the rate effective on Monday to Friday is applicable if those rates differ. (53)

Understanding the concepts of "value date" and "spot rate" in foreign exchange trading and their impact on the definition of exchange rates is also important. "Spot rate" in foreign exchange trade refers to the rate to be used for striking a trade today but for exchanging and delivering the currencies on the "value date," which is normally two days from the date of the trade. (54) In fact, a reference bank could have any of the following three different rates on any given date, each of which can be interpreted to refer to such effective "buying or selling" rates: (1) a rate available in "cash foreign exchange market," the market for retain customers; (55)

(2) a "spot rate" in the interbank market for the delivery of the traded currencies two days after such date; and (3) a rate under which currencies are delivered at such date and which was the spot rate effective two days before such date. Unfortunately, many loan agreements do not clearly identify the applicable rate. Some loan agreements refer to the applicable exchange rate as the "spot rate." Many other agreements simply define the exchange rate as the "buying or selling" rate. Although one may argue that the effective "buying or selling" rate refers to the spot rate effective at the date of determination, this should be made clear in order to avoid ambiguities.

Selection of the applicable spot rate as between (1) the spot rate in effect two days prior to the date of the determination, which means the rate the value date of which is the date of the determination, and (2) the spot rate in effect on the date of determination, is also important. In most cases where exchange rates are used, the parties intend to ascertain the amount that should be paid in a different currency on the date of the determination, not two days after such date. For instance, if a lender must determine the dollar equivalent of payment made in yen, so as to ascertain how much the dollar loan is reduced, the real question is how much the lender receives in dollars on the date when the payment is made, not two days after the payment. In the open market, it is the spot rate effective two days prior to the value date, rather than the spot rate in effect on the date of the payment, that determines how much the lender may receive in dollars on the date such lender receives the yen payment. As a result, lenders should consider defining the exchange rate as the spot rate two days before the date of the determination, at least with respect to matters relating to payments and advances. (56) Otherwise, lenders that artificially fix an exchange rate to measure these payments and advances may cause the loan to be undervalued, and the payment or the collateral to be overvalued.

#### Requirement of Convertibility

Market conditions may affect currency convertibilities. Some currencies have a more established market than others, and therefore greater liquidity and convertibility. In most cases, the convertibility of a currency is affected by exchange control regulations of the government having jurisdiction over either the currency or the parties. Not only does convertibility determine whether the lender is able to acquire funds to discharge its funding commitment, it also directly impacts the value of the repayments and the ability of the borrower to make them. If a currency is not readily convertible, then the borrower might not be able to repay its debt in the currency required under the loan agreement. Thus, without significant restrictions on the repayment currency in the loan agreement, the convertibility of the loan currencies is particularly important. (57) Convertibility is a less important issue if the loan agreement expressly identifies the loan and repayment currencies, but the lenders should note that the convertibility of the loan currencies may change before the loans are fully repaid. Historical market volatility with respect to a particular loan currency, and the financial, economic and political stability of the home country of the loan currency should also be considered when evaluating whether the convertibility of a loan currency may deteriorate during the life of the loan agreement. Thus, lenders should identify and limit their lending commitments to the currencies that are freely convertible (58) as a matter of law and that have an established international market.

In standard loan agreements, lenders have commonly relied upon "illegality clauses" and "yield protection clauses" to deal with risks associated with currency convertibility. Depending on the special circumstances of each transaction, these clauses might not fully address the convertibility issue. (59) For instance, the illegality clause may be inapplicable if the relevant exchange regulations limit or restrict the convertibility of the currency by the imposition of approval procedures or quota systems. Furthermore, under a standard yield protection clause, convertibility may not translate into direct funding costs recoverable by the lender. Accordingly, lenders should consider drafting provisions dealing directly with convertibility problems. For instance, the loan agreement should give the lender the flexibility to cancel its lending commitment if changes in the financial market or applicable law materially affect the convertibility and liquidity of any loan currency.

A lender should also request the right to designate a different

payment currency if the loan currency is no longer convertible or if its convertibility is significantly restricted. Alternatively, the lender also may seek the ability to call the outstanding loan when market conditions for a particular loan currency have so changed that in the judgment of the lender, the currency risks associated with the loan have materially increased. Finally, currency convertibility is a vague concept and the parties to the loan agreement are likely to disagree on its interpretation, especially when convertibility is not entirely restricted, as in the case of "managed" or "limited" convertibility. (6) The loan agreement therefore should give the lender the right to determine what constitutes "freely convertible."

Convertibility problems often result from changes in the foreign exchange regulations in the borrower's home country or the jurisdiction where the loan proceeds are used. Consequently, those countries' economic, financial and political stability, as well as other factors relating to the assessment of sovereign risks, are relevant to the evaluation of the lender's exposure relating to convertibility. Furthermore, the IMF has imposed a variety of limitations with respect to the ability of its member countries to regulate their own currencies and foreign exchange. (61) Therefore, unreasonable and arbitrary changes in a government's foreign exchange regulations are less likely to occur in countries that are party to the IMF than in countries that are not. As a result, lenders should ensure that the borrower's home country is a member of the International Monetary Fund, and that the loan proceeds are not to be used in projects located in nonmember countries. In fact, some loan agreements give the lender the right to call the loans and terminate the commitments if the borrower's home state ceases to be a member of the Fund, and where sovereign borrowers are involved, termination of membership with the IMF is sometimes an event of default.

#### Covenanton Currency Protection Agreement

Unless the borrower has an established and workable currency risk management system, the loan agreement should specifically require the borrower to adopt hedging devices that the lender considers appropriate in light of the risk level, the size of the transaction and the type of the currency involved. This usually takes the form of an affirmative covenant requiring the borrower to enter into currency protection agreements, which can be either a swap agreement, a futures contract, a currency option contract, or a forward currency contract. "Currency protection agreements" should be defined to include only those agreements and arrangements that indeed function as hedging devices. (62)

Alternatively, as seen in some loan agreements, a structure may be adopted whereby an agreement or arrangement qualifies as a currency protection agreement only if the lender approves it as such. The lender may require that such currency protection agreements cover the entire borrowing and be in place throughout the life of the loan. If the lender is comfortable with the borrower's ability to deal with its currency risk, the lender may also require the borrower to hedge a percentage of the total borrowing, or to hedge the term or bridge loan portion, for which hedging devices are readily available in the market, leaving the revolver and letter of credit portion of the facility unprotected. If a loan agreement requires the borrower to purchase currency protection agreements upon the lender's request, the lender should be given the power, where its request is not timely honored, to act on behalf of, and at the expense of the borrower, to purchase a currency protection agreement whenever, in the lender's judgment, exchange rate movements are likely to increase the borrower's exposure to an unacceptable level.

In order to ensure that the currency protection agreements will indeed help the borrower to repay its foreign currency loans, the lender should require the borrower to assign its currency protection agreements, including the settlement proceeds, if any, to the lender. In most cases, such assignment gives the lender a currency option--that is, the right to buy a particular currency at a predetermined price; however, without any obligation to do so, the onus is left on the borrower. The lender may also consider having the borrower insert a provision or request a written acknowledgement of the counterparty, giving the lender a right to enforce the terms of the agreement. The lender may further request a provision in the currency protection agreement that obligates the counterparty to give the lender prior notice before terminating the agreement, and to give the

lender the right to cure the borrower's defaults within a grace period.

Where the borrower uses futures contract or currency options to hedge its risks, the lender should request written confirmation from the borrower's brokerage firm that any amount due to the borrower from the clearing house, upon the final settlement of the futures contract, will be remitted to the lender.

The lender should note that futures contracts in the U.S. are valued and settled daily, on the basis of their market price. This means that a borrower who bought a futures contract for the delivery of 1.5 billion yen for ten million dollars three months from today will be required to pay, or will be entitled to receive a credit, on each day during this three-month period when the liquidation price of this contract is more than or less than 1.5 billion yen for ten million dollars. If the contract price moves unfavorably, and if the borrower is unable to provide cash or other collateral, the broker is entitled to liquidate the futures contract. In the event of liquidation, the borrower's brokerage firm should be required to confirm to the lender that the contract will not be liquidated prior to its maturity, unless the lender is notified and given an opportunity to cure. Furthermore, the borrower should not be permitted, as a result of price fluctuations, to withdraw cash under the credit received in its brokerage account. The money so credited actually represents the hedging protection that the contract is designed to provide. If the lender must liquidate the loan on a given date, such money will compensate the lender for the loss it incurs as a result of adverse exchange rate fluctuations.

#### Adjustment of Collateral and Availability; Mandatory Prepayment

To protect lenders from increased exposure due to exchange rate fluctuations, loan agreements may provide for periodic adjustments. (63) If exchange rate movements have increased the dollar equivalent of the lender's outstanding foreign currency loans or foreign currency loan commitment, or if movements have decreased the dollar equivalent of the foreign currency collateral, then the periodic adjustment provision would allow the lender to reduce or increase the revolving loan availability or to demand additional collateral.

Depending upon whether the lender's increased exposure is due to a decrease in the collateral value or an increase in the outstanding loans, the lender may or may not need to make adjustments. Adjustments appear to be necessary if the collateral value decreases because such a decrease makes the loans undersecured. If the increase in the dollar equivalent of the outstanding foreign currency loans is the lender's sole exposure, however, adjustments may not be necessary if the lender has matching foreign currency liabilities. In such case, the lender has an increased exposure only if the borrower defaults in the repayments; as a result, the lender needs to make adjustments only if the borrower's credit standing also deteriorates. Furthermore, if the borrower has a workable hedging contract in place--for example, a currency option contract matching its repayment obligations under the loan agreement--adjustments may not be needed because the borrower's repayment ability would not be affected by the increase in the dollar value of the outstanding loans. The lender, nonetheless, may have problems internally, because the outstanding loans may, at any given time, exceed the limit established by the lender's credit approval. This problem can be avoided by having the limit set in the loan currency, or where the limit is set in dollars, by leaving enough flexibility to accommodate the anticipated volatility in the currency market.

To make the adjustment mechanism administratively manageable, adjustments should be made when exchange rates have changed by a percentage that represents more than a negligible risk. The loan agreement should also have an effective monitoring system to allow the lender to monitor changes in the value of the collateral. To protect the foreign collateral from conversion risks or unfavorable market conditions of a different currency, the loan agreement may contain covenants prohibiting the borrower from converting assets into different currencies or transferring collateral across borders in any material amount and not in its ordinary course of business, without the lender's consent.

An adjustment mechanism that functions by reducing borrowing availability is effective if the financing is a revolving facility or has a revolving component. If the financing consists of only term loans or bridge loans, the lender may require the borrower to deposit additional collateral

or make mandatory prepayments. The borrower may find it difficult to agree to a mandatory prepayment provision, however, due to the uncertainty of the currency market and the borrower's inability to predict, and respond to, the need for mandatory prepayments.

#### Eligibility of Borrowers

Multicurrency financing often involves several borrowers. Since a foreign currency loan is often used to finance a particular foreign subsidiary, in order to avoid tax and intercompany transfer problems associated with downstreaming under foreign laws, the borrower may prefer to include the foreign subsidiary as a borrower for the related foreign currency loan. However, different borrowers, even within the same corporate group, could create different risk levels and different costs to the lender. Thus, the lender should ensure that change or substitution of borrowers would not increase its exposure before it includes the foreign subsidiary as a borrower.

If the loan document gives the parent company the right to designate borrowers among its subsidiaries, the lender could restrict borrowers' options by defining "eligible borrowers" in the loan agreement. The lender also could screen the eligibility of the borrowers in light of the considerations set forth above, prior to the closing. The lender may minimize its currency risk by requiring the subsidiary borrower to meet certain assets and cash flow criteria to ensure that only the borrowers with foreign currency earnings and foreign currency assets may borrow in that particular foreign currency. Unless there are special business considerations, a lender should ensure that the borrower has cash flow and saleable assets in the loan currency sufficient to meet the borrower's repayment obligations. This could eliminate the risk of loss due to currency conversion, which may be necessary for the repayments of the loan and for liquidating the assets. This is especially true in cases where the borrowing was made in a "strong" currency and the borrower's source of repayments is in a "weak" currency.

In determining the borrower's eligibility, the lender should also consider applicable laws and regulations that may impose different requirements, which in turn could mean different costs to the lender, depending on the borrowers' geographic locations. For instance, under Regulation D, the lender may incur a reserve cost if the borrower is a U.S. parent company, instead of its foreign subsidiaries located in a foreign country. (64) Therefore, the lender should make sure that the borrower pays any additional cost the lender may incur as a result of the substitution of the borrowers. (65) This is particularly important if the interest rate calculation does not include the potential reserve costs and is based on the presumption that the lender will not incur such costs under the existing loan structure, or if the lender has reflected its savings on the reserve costs in the loan pricing.

Different borrowers may also have different impacts on the lender's capital costs under the new Risk-Based Capital Guidelines (Guidelines) promulgated by the Federal Reserve. (66) The Guidelines, which took effect on March 31, 1989, impose different capital requirements for banks' assets subject to different risk levels. These levels are determined by, among other factors, the locations and financial strength of the borrower and guarantor. (67) Loans made to certain sovereign borrowers (68) are categorized as "zero risk" assets without capital cost, (69) whereas loans to the central governments of other countries are categorized as "100% risk" assets with the highest capital cost imposed by law. (70) Loans to private parties guaranteed by an international organization such as the World Bank or a regional development bank could also reduce the lender's capital cost. (71) The Guidelines have many other detailed provisions that should be studied when determining the lender's capital cost and loan pricing for different borrowers.

#### Currency Limits

By establishing a limit for each specific currency, the lender can protect itself from excess exposure in one or a few currencies, and can define the maximum exposure as to each of the loan currencies. The currency-specific limits are particularly useful to the lender in a revolving facility, or other committed but unborrowed facility where the borrower has discretion to increase or decrease the borrowing and to determine when to borrow. The limits prevent the borrower from unlimited borrowing in all applicable currencies without regard to its repayment

ability in the borrowed currency. The limits also allow the lender to manage the currency risk of the transaction with greater certainty and to spread risk more evenly. The borrower is likely to request flexibility and to resist limits that may not match its undetermined future needs of each loan currency. In such a case, a compromise can be reached by allowing the borrower to request that the lender make periodic adjustments to the existing currency limits when borrowing in a particular currency becomes unavailable or unnecessary, while the borrowing need for other currencies increases. The lender will have the opportunity to determine whether to increase the borrowing limit based upon the market condition of a particular currency and the borrower's repayment ability in that currency.

#### Definition of "Liabilities"

In a loan agreement, the term "liabilities" normally defines the scope of the borrower's obligations to the lender arising out of the loan transaction and, in a secured lending, the scope of the debt secured by the collateral. The definition of "liabilities" found in standard loan agreements often contain broad language that, if favorably interpreted, may be used for a multicurrency financing. A lender may wish, however, to tailor the definition to the special needs of a multicurrency financing. For instance, the lender may consider including a reference to the borrower's liabilities relating to currency devaluation or depreciation while any loan or liability to the lender remains due. If the loan agreement authorizes the lender to take action on behalf of the borrower to hedge the borrower's currency risk, "liabilities" could also include any costs or expenses incurred by the lender as a result of such action. In addition, if the lender requires the borrower to use the lender's foreign exchange trading service to hedge against currency risks, "liabilities" should include any additional obligations the borrower incurs as a result of any currency protection agreement it enters into with the lender or the lender's affiliates. However, in a syndicated loan involving a number of banks, a lender that does not provide the borrower with hedging arrangements may find that this broad definition encroaches upon its interests. In such a case, a compromise may be reached by establishing certain dollar limits on the amount of hedging-related liabilities.

Defining "liabilities" broadly, to borrower's indebtedness and obligations to the lender with respect to currency risks, would give the lender a contractual right to be paid for expenses and losses that may or may not be clearly allocable to the borrower. It also ensures that the lender's claims are secured by collateral, and the expenses incurred by the lender in enforcing its claims are paid by the borrower under the standard provisions of the loan agreement.

#### Interest Rate Reference

Under most loan agreements, applicable interest rates for foreign currency loans are determined on the basis of either LIBOR, (72) offered by certain money center banks, or the rates appearing on the Reuter screen (73) or in other similar publications. For a currency that is not regularly and actively traded in international financial markets, a basic rate may not be available at all times. A lender with a strong bargaining position may have the borrower accept the rate quoted by the lender, which normally is coupled with the borrower's right to prepay the loan. In some loan agreements, however, the lender and borrower negotiate a mutually acceptable rate; but if they cannot agree on the applicable rate, then the borrower may elect to prepay the outstanding loans. Other loan agreements attempt to counter lenders' use of bargaining power to impose the applicable interest rate on the borrower by providing an alternative "foreign currency domestic rate," which is the interest rate offered by a foreign bank located in the country issuing such foreign currency. A "foreign currency domestic rate" ensures that there always will be an applicable interest rate for a foreign currency loan. However, the interest rate offered by a foreign bank may not necessarily reflect the market rate applicable to the lender if there is no established credit market existing in the foreign country, or if the lender does not have access to the funds at that rate. Thus, the loan agreement should make clear that the definition of "foreign currency domestic rate" refers to a rate offered to the lender. This clarification could help to avoid disputes in cases where a foreign reference bank offers double "foreign domestic rates," one rate applicable to domestic businesses and a different rate applicable to foreign banks.

In a similar vein, with respect to the borrower's option to select interest periods, the lender should note that for some foreign currencies highly standardized markets similar to the Eurodollar market may not exist, so interest periods for loans in each foreign currency should be consistent with the interbank practice with respect to that currency.

#### Covenant on Intercompany Transfers and Arms-Length Transactions

Many loan agreements have covenants requiring the borrower and its affiliates to deal with each other at arm's length and prohibiting gratuitous intercompany transfers of assets, in order to ensure that the borrower's resources are not depleted to enrich other members of the borrower's corporate group. If a structured subordination exists among lenders, with senior lenders lending to the operating company and junior lenders extending credit to the parent company, or where for some other reasons one lender places its loan at one level, either parent or subsidiary, and another lender places loans at a different level, the aforementioned covenants will ensure that the senior lenders receive the full benefit of the subordination without diluting their interest.

Lenders should consider several foreign currency-related intercompany arrangements when drafting covenants governing intercompany transfers. However, the following two intercompany practices commonly found among multinational borrowers should be particularly noted.

First, under some centralized currency risk management systems practiced by a number of multinational corporations, assets denominated in various currencies are sometimes transferred among the members of their respective corporate group, located in various foreign jurisdictions, as a way to balance their overall currency risk on a global basis. In order to take advantage of tax and other preferential treatments available in foreign jurisdictions, a borrower may need to place certain currency losses with one subsidiary and currency gains with a different company. The transfer of foreign exchange losses and gains can be achieved by, among other methods, manipulating the currencies used for intercompany pricing and billings. For instance, a manufacturing subsidiary that pays for raw materials, labor and other production costs would not incur a currency loss as a result of exchange rate fluctuations if such subsidiary is able to sell its products to a member (e.g., a marketing subsidiary) of its corporate group for the same currency in which it incurs costs. If the products are to be sold overseas for a different currency, then this arrangement allows the manufacturing subsidiary to transfer the currency risk to the marketing subsidiary. On the other hand, if the manufacturing subsidiary is required to price and bill in the currency for which the goods will ultimately be sold to a third party, the currency risk would be placed with the manufacturing subsidiary rather than the marketing subsidiary. (74) A conventional covenant requiring the borrower to deal with its affiliates at arm's length may conflict with the borrower's effective business practices.

Second, in many multinational corporations having significant business relationships with their foreign subsidiaries, intercompany billing may be based on an exchange rate that does not necessarily reflect market rates. For instance, some companies adjust, monthly or quarterly, the exchange rates used for intercompany transfer pricing, while others follow short-to-medium-term planning cycles. (75) Depending upon the volume of such intercompany business dealings and the exchange rate movements, these intercompany exchange rate adjustments may affect a lender's interest vis-a-vis other lenders extending credit to the other members of the same corporate group.

Without unduly interfering with legitimate foreign currency-related intercompany practices, lenders in a highly leveraged transaction may consider imposing certain limits. For instance, a cap based on prior practice may be imposed on the total amount of transfers. Furthermore, the lender may consider requesting that the transferee give the lender a secured limited guarantee in an amount equal to the transfer.

#### Covenants with Respect to Currency Risk Management System

As noted earlier, as part of a lender's due diligence it should assess the borrower's currency risk management system (if any), and determine the borrower's currency exposure in its ordinary course of business. If the lender determines that the risk management system in place prior to the closing is adequate in light of the borrower's exposure, the loan agreement should contain a covenant requiring the borrower to maintain



the system as is, and not to modify or adjust it in a way that has the effect of increasing the borrower's exposure, without the lender's prior written consent.

The borrower's risk management system is often embodied in a statement of policy or instructions, issued by the head office to the operational personnel, setting forth the policies and procedures of the company on how to handle foreign currency problems. In such a case, the lender may include such statement as a schedule or exhibit to the loan agreement in order to monitor the borrower's future compliance with the covenant. If the borrower does not have a risk management system in place, and if the borrower's business operation indeed involves a significant currency risk, the lender may want to require the borrower to establish a system that is satisfactory to the lender, in light of the borrower's business and the scale of its international operations, either before the closing or within a specified period thereafter.

#### Financial Covenants and Currency Risk

A borrower's exposure to currency risks, and the losses that sometimes result from such risks, often occur in the borrower's current account. Unless the borrower sells or the lender forecloses on the borrower's fixed assets, the loss to the borrower's fixed assets as a result of the currency risk appears only in the borrower's financial statements, and may be offset later if the exchange rate moves in a favorable direction. As a result, in most cases the borrower's exposure can be significantly reduced if the borrower can maintain a current ratio of approximately one to one with respect to the current assets and liabilities denominated in the same foreign currency. In such a case, any increase in the borrower's current liabilities resulting from the exchange rate movements will be offset by a corresponding increase in its current assets.

For this reason, the lender may consider including a "foreign exchange current ratio" provision in the financial covenants, requiring the borrower to maintain on a consolidated basis a specified ratio of its current liabilities to its current assets in each foreign currency. Such a covenant can also serve to prevent the borrower from engaging in speculative currency transactions by taking a significant unhedged position in an appreciating foreign currency, or more commonly by keeping its excess cash in a particular currency in order to take advantage of the higher interest rate.

Although the "foreign exchange current ratio" needs to be one-to-one in order to eliminate the borrower's currency risk, the lender should leave enough flexibility to accommodate the borrower's business and other legitimate needs. For instance, the lender may allow the borrower to keep a certain amount of cash in the currency in which it is most likely to be required for future expenditure, in order to minimize the currency risk. As future expenditures may not be reflected as current liabilities, a strict requirement of a one-to-one ratio may cause difficulties for the borrower's risk management planning. Furthermore, the tax position of all foreign subsidiaries of a multinational borrower may not be the same because the tax treatment of exchange gains and losses is not internationally uniform. Where the gain in one subsidiary is taxable but there is no allowance permitted for the corresponding exchange loss in another, the borrower may need the flexibility to make adjustments in its position in different currencies. To accommodate the borrower's need for operational flexibility, the lender may identify a number of currencies that historically have been unstable, and are therefore likely to pose risks, and require the borrower to maintain the foreign exchange current ratio only with respect to those high-risk currencies. (76)

When structuring financial covenants in a multicurrency financing, the lender should note the different impacts of the exchange rates on different items of the borrower's assets and liabilities. Normally, monetary items such as cash, debt, and accounts receivable and payable in foreign currencies are much more directly affected by the exchange rate movements than nonmonetary items such as real property and inventory, because of the foreign currency value of those nonmonetary items could change in the form of price inflation or deflation, which may compensate the loss. As a result, the lender should pay special attention to the structure and components of the borrower's cash and debt management system. For instance, the borrower should not be allowed to incur unhedged long term foreign currency debt, and such restrictions should be clearly stated

in the section on "permitted indebtedness." When fixing various ratios in the financial covenants, a lender should ensure that the borrower's foreign exchange cash flow is properly managed.

#### Syndication

Syndication of a loan facility could be complicated by multicurrency components and by various provisions and devices designed to deal with lenders' currency exposure. First, lenders' needs for protection against currency risk differ. Generally, lead lenders are large money center banks that, unlike most of the syndication banks, have experience in multicurrency transactions and have the financial strength to deal with and absorb the currency risk. If the loan documentation is structured solely with the interests of the lead lenders in mind, then the currency risk protection provided for in the loan documentation may appear inadequate to the syndication lenders. The lead lender should consider providing a protection comparable to the risk level of most of the lenders to be included in the syndication to minimize the difficulties in the syndication. Furthermore, many multicurrency financings have one large dollar facility and two or more much smaller foreign currency subfacilities. If, like many of the multicurrency facilities in the market, the structure is that of a traditional single currency syndication ratably shared by all lenders, (77) each lender's share of the loan under the smaller foreign currency subfacility may be so insignificant that it may be difficult for lenders to obtain funds through match-funding or other means as reasonable cost. (78)

As a result, the lead lender should have a clear idea about what the size of the bank group in the syndication should be. In addition, the minimum borrowing amount under the foreign currency subfacility should be large enough to allow each lender in the syndication to have a marketable piece. Finally, it is important to note that there is less certainty and stability in the secondary market for currencies other than dollars. Even if the market for each loan currency is well-established individually, there remains a question whether a similarly established market exists when those currencies are bundled together.

#### Multiple-Currency Clauses

Multiple-currency clauses allow the borrower to repay, or the lender to demand the repayment of, a foreign currency loan in a currency other than the currency in which the loan was made. A multiple-currency clause in favor of the borrower (79) is often intended to provide flexibility, especially in cases where a large part of the borrower's cash flow is not in the loan currency. (80) Since a multiple-currency clause could give the borrower an opportunity to profit from exchange rate variations at the lender's expense, the lender normally refuses to grant such flexibility. (81) Where the borrower to a few stable and highly convertible currencies, restrict the manner in which the option may be exercised, and most importantly, provide for contingencies under which the payment option may be terminated.

The lender should pay particular attention to the exchange rate used to determine the value of the borrower's repayment as measured in the loan currency. In most cases, the exchange rate should be the rate effective when the lender receives the payment, or at the lender's election, when the payment is due. (82) By using the payment-day rate, the lender essentially buys the loan currency on behalf of the borrower to repay the loan, and the currency risk remains with the borrower.

A multiple-currency clause designed to benefit the lender normally requires the borrower to repay the loan in the loan currency, or if the lender so elects, in a different currency specified in the agreement. The amount of repayment in such currency is determined using the exchange rate effective on the funding date, or in some cases, as specially provided in the loan agreement. (83) If the borrower does not have to make a one-time draw on the closing, but instead may borrow any time within a specified period after the closing, the former approach could protect the lender from locking itself to an unfavorable rate. A multiple-currency clause has the benefit of preserving the value of the loan because it creates a currency option allowing the lender to receive a particular currency at a predetermined rate. It also protects the lender when foreign exchange regulations make it illegal for the borrower to remit payment in certain currencies.

#### Loan and Judgment Currency

In a situation where suit is necessary to enforce the loan agreements, the value of a lender's recovery directly relates to (1) whether a judgment for the lender may be denominated in the currency in which the payment was originally due or a currency the lender selects, and (2) if the court refuses to issue a judgment in such currency, how the court converts the loan currency into the judgment currency. Except for Great Britain, which has recently developed new rules, (84) courts in common law jurisdictions, particularly American courts, (85) have refused to enter judgments in foreign currencies. When deciding cases involving foreign currency liabilities, courts of common law jurisdictions, with the exceptions noted, will convert the foreign currency liabilities into dollars, or into the domestic currency of the state or nation in which the court is sitting. Thus, a lender suing for unpaid principal or interest in a foreign currency can recover only in dollars or the domestic currency of the court. (86)

Although commentators have urged that this rule be reconsidered, "there has been no reported decision of a U.S. court in which a judgment was granted in a foreign currency, whether on a claim denominated in a foreign currency or on a judgment of a foreign court stated in a foreign currency." (87)

The currency denomination of a judgment might not be material if the lender can recover the full value of its losses, and if the judgment currency is fully convertible. The important issue is which exchange rate a court uses to determine the amount of the lender's recovery in the judgment currency. American courts have invoked several different measures for determining the rate of exchange to be used in converting the judgment currency: the breach-day rule; the judgment-day rule; the payment-day rule; and the trial-day rule. (88) The Uniform Commercial Code appears to endorse the breach-day rule; it provides that the dollar amount of recovery on an instrument payable in foreign currency is "determined by the buying sight rate for the foreign currency on the day the instrument becomes payable." (89) Most state and federal decisions follow either the judgment-day rule or the breach-day rule depending on the circumstances of the case, particularly the governing law and the place of payment. (90) "If the obligation arose entirely under foreign law, the judgment-day rule applies; damages incurred in foreign currency are converted into dollars at the rate prevailing on the date of final judgment. (91) On the other hand, if the plaintiff has a cause of action under American law, the breach-day rule applies, and the applicable rate is that prevailing when the cause of action arose." (92)

Whether a given exchange rate is favorable to a particular lender depends on many factors, including the following: (1) currency rate fluctuations; (2) the functional currency of the lender; (3) accounting practices of the lender; (4) the currency in which the funding cost is incurred; and (5) the currency in which the judgment is denominated. For instance, a U.S. lender might find the breach-day rule acceptable because it can receive the same amount of dollars it would have received had the borrower not defaulted. (93) However, where a lender who "match-funded" its foreign currency loan "rolls over" its foreign currency liabilities instead of liquidating its position, that lender might incur a loss if the breach-day rule is applied and the foreign currency has since appreciated, making the dollar amount determined under the breach-day rule insufficient to satisfy the lender's matching foreign currency obligations. (94)

In such case, the exchange rate effectiveness when the lender recovers best serves the lender's interest. Likewise, for a Japanese bank using yen as its functional currency, the breach-day rule would result in a loss if yen were to appreciate to the extent that the dollar amount recovered on the judgment-day, or on the date of actual payment, is insufficient for the bank to purchase yen on the open market in an amount equal to its yen loan. With respect to such a Japanese bank, the exchange rate in effect at the time it actually gets paid is the most appropriate. (95)

Although it is difficult to determine abstractly whether the breach-day rule or the recovery-day rule is the most beneficial to a lender, the judgment-day rule is always problematic, and is the least preferable measure. For example, the uncertainty as to the date of the judgment makes the value of the lender's recovery speculative. The likelihood of currency fluctuations between the date of the breach and the

day of the judgment also makes the judgment-day rule unattractive to lenders. (96)

Lenders would prefer to have the option to select the applicable exchange rate, or at least to allow the courts the flexibility to use the most equitable exchange rate measurement. Although some authorities have urged the courts to do so, (97) at least American courts have so far resisted such a proposal. Recent reform proposals have advocated allowing courts discretion in selecting which rule to apply in order to meet the objective of placing the lender in a position as close as possible to that it would have occupied had the borrower fulfilled its obligation, or if the injury had not occurred. (98)

For instance, the Restatement of Foreign Relations Law encourages the use of the recovery-day rule, yet maintains that "a judgment in dollars should be given on the basis of conversion at whichever date would serve the ends of justice in the circumstances." (99) This approach calls for the conversion to be made "at such rate as to make the creditor whole and to avoid rewarding a debtor who has delayed in carrying out the obligation." (100) A recent United Nations Convention also adopted an approach favorable to lenders. (101) Once becoming effective, however, the Convention will apply only to negotiable promissory notes. (102) As a result, most of the notes issued in connection with multicurrency financings would not be able to benefit from the Convention's favorable provisions.

Most loan agreements attempt to integrate the recovery-day rule into the contract as a way to prevent courts from taking different approaches when determining the dollar value of a judgment. Such a provision normally states that where the borrower pays its obligations in a currency other than the loan currency pursuant to a judgment, the borrower's obligations to the lender can be discharged only if the amount the lender receives allows the lender to purchase the loan currency in an amount equal to the obligations originally due on the day when the lender receives the payment. (103) If the judgment amount under the exchange rate effective on the recovery day turns out to be less than the foreign currency liabilities originally due, the borrower has a separate and independent obligation to compensate the lender for the shortfall. (104)

Standard judgment currency provisions, such as those put forth here, are commonly found in multicurrency loan agreements, but do not necessarily provide protection for all lenders. Each lender should review its funding policy with respect to its foreign currency loans and its write-off practice for overdue foreign currency loans, in order to determine whether the judgment currency provision provides adequate coverage. A lender should note that the recovery-day rule offers protection only if its losses arise in a foreign currency, as in the case of a foreign lender whose functional currency is the loan currency. A U.S. lender may feel comfortable with this approach if the foreign currency loan was funded by its overseas branch, or by incurring foreign currency obligations to a third party under a currency swap or match-funding. Such foreign currency obligations remain outstanding when the lender recovers under the judgment. In either case, the recovery-day rule would allow the lender to receive, on the date when the payment is actually made, an amount of the foreign currency sufficient to compensate for the lender's net loss in such foreign currency, or to satisfy the lender's foreign currency obligations to a third party.

With respect to other lenders, including some banks, mutual funds, insurance companies or private investors buying a participation in a foreign currency loan, the recovery-day rule may not provide the best recourse. It is likely that these lenders enter into a currency swap or similar arrangement in order to acquire the foreign currency needed to meet their funding obligations. When the borrower defaults, they must purchase the foreign currency to discharge or otherwise liquidate their foreign currency obligations to their counterparties. As in the case of banks that no longer have matching foreign currency liabilities at the time a judgment is paid, these lenders' losses in the foreign currency have been translated into dollars on the breach day, and therefore the lender could best be protected under the breach-day rule, not the recovery-day rule. (105)

A lender with strong bargaining leverage may seek to compel the borrower to allow the lender to choose the more favorable exchange rate at the time the payment is due, and at the time the payment is received by the lender. (106) Without such protection, a lender may need to adjust, in light of the wording of the judgment currency provision--or absent such

provision, the applicable law--its lending and funding practices in order to minimize its exposure. A lead lender should also consider the impact of the judgment currency provision on the interests of potential syndication lenders, and therefore the possible effect on the syndication of the loans.

#### Conclusion

Currency risk is speculative, allowing parties to profit as well as lose. As a result, any attempt to hedge a currency risk, except for a currency option or another similar arrangement, will eliminate a parallel opportunity to benefit from fluctuations in currency values. Obversely, failure to hedge a currency risk may lead to a loss as well as a windfall profit. While this speculative balance of gains and losses generally applies to a borrower, a similar balance exists, although to a lesser degree, with respect to the lender, because the borrower's loss due to its currency exposure may directly impact the lender's interest. As a result, lenders should carefully analyze the currency risks and take precautions to minimize not only their currency exposure, but that of the borrower as well.

In most transactions, the lender's need to adjust loan documentation and financing structures to deal with the currency risk ultimately depends upon the level of the lender's currency exposure, which necessarily and significantly varies from transaction to transaction, depending on the lending structure, the nature of the borrower's business operations, the borrower's financial strength, the lender's experience, and the scale of both parties' international operations. If a lender is comfortable with the currency risk in a transaction, it may document the loan as if it were domestic financing.

Although this article generally should help lenders understand and deal with currency risks, lenders should remember the particular needs of their transactions when considering structural and documentational approaches to deal with currency exposure. The approaches and provisions outlined in this article may work well in some transactions, but not so well in others. The feasibility of any approaches in a specific transaction must be determined by the lender on a case-by-case basis.

(1) International banking is a by-product of the colonial expansion of Britain and European countries during the late 19th century. "By 1914, when the first foreign branch of a U.S. national bank was opened . . . , there were reportedly some 2,000 overseas branches of European banks." Mueller, A Conspectus for Offshore Lenders, in OFFSHORE LENDING BY U.S. COMMERCIAL BANKS 1, 2 (F. Mathis 2d ed. 1981). The international banking activities of the U.S. banks were limited by The National Bank Act of 1864, under which U.S. banks could not open branches overseas. National Bank Act of 1864, ch. 106, [section]5, 13 Stat. 99 (current version at 12 U.S.C. [section] 21 (1988)). However, upon passage of the Federal Reserve Act of 1913, U.S. national banks were allowed to establish branches overseas. Federal Reserve Act of 1913, ch. 6, [section] 1, 38 Stat. 251 (codified as amended at 12 U.S.C. [section] 221 (1988)). Mueller, *supra*, at 1-2. Recently, the expansion of multinational corporations has led financial institutions to engage in international banking in order to service their international corporate clients. This expansion has been mirrored by an increase in international commercial lending. The development of international commercial lending is due to a combination of a variety of factors including the following: the expansion of international trade; the reduction of national barriers to the free flow of foreign capital; the creation of a mature international financial market; and the rapid development of international communication. See generally *id.*

(2) United States banks' international assets have declined recently due to a reduction of their nonperforming Third World debts. These debts have been reduced by write-offs, swaps, sales, and securitization in response to the tightening of federal regulations and the deteriorating repayment ability of Third World borrowers. See, e.g., Kraus, US Banks Shrink Foreign Portfolios, *Am. Banker*, May 22, 1989, at 8, col. 2. United States banks' international lendings remain a large source of international credit despite a \$100 billion decline in their foreign exposure, to approximately \$260 billion in 1989. See *id.*

(3) "Eurocurrency" is used in this article in a broad sense to include "any currency on deposit in a land where the currency is different." Logue, Overseas Money and Capital Markets, in FINANCIAL HANDBOOK 13.10 (E. Altman 5th ed. 1981). Eurocurrencies include

"Eurodollars, Panama dollars, Hong Kong dollars, and so forth. . . . Principal Eurocurrencies include U.S. dollars, German marks, British pounds, French francs, Swiss francs, and Japanese yen." Id.

(4) In fact, many multinational corporations require their foreign subsidiaries, as a corporate policy, to obtain both short- and long-term financing in the currency of the country where the borrowing subsidiaries are located. See, e.g., M. DUERR PROTECTING CORPORATE ASSETS UNDER FLOATING CURRENCIES 23 (1975).

(5) Recent statistics show that major banks' international assets have outperformed domestic assets. For instance, in 1988, Chemical Bank's international assets, which represented 19% of its total assets, generated 52% of its earnings. Similarly, Manufacturers Hanover attributed 55% of its total earnings to international assets representing 35% of its total assets. See Weinstein, NY Banks Boost Profits, Shrink Assets Abroad, Am. Banker, May 30, 1989, at 1, col. 2, 15, cols. 3-4.

(6) Keller, Lend the Money, Then Sell the Debt, EUROMONEY, Aug. 1989, at 99. See also Too Much Money Chasing Too Few Deals, EUROMONEY: LEVERAGED FINANCE, EVERY ONE A WINNER?, May 1989 (Special Supplement), at 14; Cates, New Strategies Needed to Cope with Overcapacity in Banking, Am. Banker, May 10, 1989, at 7, col. 1.

(7) "[C]orporates would be unlikely to be happy dealing with a number of banks when they could deal with one bank is able to create a whole package." INTERNATIONAL FINANCIAL HANDBOOK--A WORKING HANDBOOK 3.3-16 (M.Z. Brook & J. P. MacArthur eds. 1988).

(8) It may not be profitable for a borrower to borrow in a currency bearing a lower interest rate than another, because the two currencies' applicable forward exchange rate is often determined by, among other factors, the differentials in the interest rates of the two currencies. As a result, the borrower may have to pay a risk premium equal to or exceeding the amount the borrower saves by taking its loan in the currency with the lower interest rate. Indeed, many U.S. companies suffered severe losses by borrowing in Swiss francs during the late 1960s and early 1970s, when they had hoped to benefit from the lower interest rates. J. HEYWOOD, FOREIGN EXCHANGE AND THE CORPORATE TREASURER 38-39 (1978). However, exchange rates are affected by many other factors, such as the balance of payment positions of the respective states, inflation, and political stability. Therefore, exchange rates do not necessarily match the differentials of the interest rates in different currencies. In fact, the exchange rates usually do not move with the interest rates applicable to the pertinent currencies. Kern, Fundamental Analysis, in MANAGEMENT OF FOREIGN EXCHANGE RISK 57-58 (B. Antl & R. Ensor 2d ed. 1982). Furthermore, the interest rate differentials reflected by the market may not be the same as the differentials that determine the relevant forward exchange rates because credit policies vary from country to country and from economy to economy. For these reasons, a sophisticated borrower could profit by manipulating its borrowings across currencies. See Waldner, Using Currency Forecasting to Reduce Borrowing Costs, in MANAGEMENT OF FOREIGN EXCHANGE RISKS, supra, at 165-69; see also Waldner, How to Borrow in a Foreign Currency, EUROMONEY, June 1980, at 96.

(9) Banks may either borrow foreign currencies directly from the interbank market or swap their own domestic currencies for foreign currencies. See INTERNATIONAL BANKING MANAGEMENT AND STRATEGIES 21 (D. Zenoff ed. 1985).

(10) This risk is closely related to sovereign risk, country risk, and political risk in international lending. See, e.g., Whiting, Country Risk Analysis--Noneconomic Factors, in THE INTERNATIONAL BANKING HANDBOOK 85 (W. Baughn & D. Mandich eds. 1983); Trifari and Villamil, Country Risk Analysis--Economic Considerations, in THE INTERNATIONAL BANKING HANDBOOK, supra, at 102.

(11) Prior to the dollar devaluation in 1971, countries that were parties to the Bretton Woods Agreement had devalued and revalued their currencies from time to time. But overall, there were "reasonably stable" exchange rates that provided benchmarks that were sufficiently consistent and reliable for most business planning. M. DUERR, supra note 4, at 1. This "reasonably stable" system was primarily founded on the fixed conversion rate between dollars and gold (\$35 per ounce) that had been in effect since 1934. There was also a relatively fixed conversion rate between the dollar and the sterling that rarely changed. Other major world currencies were

fixed in value either to the dollar or to the sterling or both, and were thus indirectly linked to gold.

(12) Id. However, it should be noted that the free floating system is subject to various limitations. For instance, because the exchange rate often has a significant impact on the economies of the respective countries and on those countries' imports and exports, central governments often intervene in the free market by buying or selling particular currencies, or by adjusting interest rates to influence the movement of the exchange rates. Thus, "free floating" is largely "managed floating." However, the extent to which a central government can influence exchange rates is limited. For instance, buying or selling in the currency market is limited to the amount of the buying or selling countries' foreign exchange reserves. In addition, the adjustment of interest rates in the domestic currency is limited by its potential impact on the domestic economy.

(13) THE CUOMO COMMISSION ON TRADE AND COMPETITIVENESS, THE CUOMO COMMISSION REPORT: A NEW AMERICAN FORMULA FOR A STRONG ECONOMY 91 (1988) [hereinafter CUOMO REPORT]. For example, the dollar fell on average by over 28% against major currencies from March 1985 to December 1986 and fell another 15% in 1987. See INTERNATIONAL MONETARY FUND, ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 1988, at 9 (1988) [hereinafter INTERNATIONAL MONETARY FUND, 1988 ANNUAL REPORT].

(14) WORLD BANK, THE WORLD BANK ANNUAL REPORT 1989, at 29 (1990).

(15) In this article, the term "foreign currency" means, "[a] currency other than the functional currency of the entity being referred to." FINANCIAL ACCT. STANDARDS BD., ACCOUNTING STANDARDS F60.408 (1987). A "functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash." Id. at F60.415. In addition, the Financial Accounting Standards Board sets forth guidelines for determining the functional currency of an entity that conducts a significant amount of business in more than one currency. See id. at F60.106-12.

(16) Currency exposure is commonly considered to include the following: (i) "cash flow risk" or "transaction risk" that arises from transactions involving foreign currencies; and (ii) "balance sheet risk" or "translation risk" that results from translation of the balance sheets of foreign subsidiaries or balance sheet items denominated in foreign currencies. See J. HEYWOOD, *supra* note 8, at 66. However, in a multicurrency loan transaction, in addition to the lender's transaction risk, the lender's exposure also includes the borrower's transaction risks in the relevant loan, and in any other transactions to the extent that such risks impair the borrower's ability to repay the loan. Similarly, any translation risk of the borrower is a transaction risk to the lender if the collateral securing the loan consists of the borrower's foreign assets. Therefore, a lender's exposure in a multicurrency financing is more accurately calculated by considering the potential cash loss to the lender as a result of the loan, and the increased exposure to the lender, because the borrower's currency risk impairs its repayment ability.

(17) A lender with extensive international operations may not have this exposure due to its ability to adjust its foreign exchange position on a global basis. Alternatively, a large part of the lender's interest income can be hedged by matching its third party interest obligations to its interest income from the borrower. However, in the latter case, the lender is unable to hedge its profit margin, which is the spread between the interest the lender pays and the interest it receives.

(18) This exposure is normally eliminated by the "yield protection" provision, customarily found in most loan documents, which allows the lender to shift such increased cost to the borrower.

(19) Although domestic lending may have similar problems, lenders in cross-currency lending have a much greater exposure because of the greater volatility of the currency market. Unlike the domestic market for certificates of deposit and federal funds, which are primarily influenced by the performance of the domestic economy and by the policies of the Federal Reserve System, the movement of the foreign market, which is the source of funds for most lenders, appears to be more complicated and less manageable. Furthermore, many international, political, and economic developments could affect the movement of the international currency market, and these factors are far less predictable than those affecting the domestic financial

market.

(20) See *infra* notes 94-97 and accompanying text for a discussion of the related legal and documentation issues.

(21) This exposure can be reduced if the collateral, the borrower's cash flow, the loan, and the expected repayment are all denominated in the same currency. A financing in such a currency is more precisely described as a financing in "functional currency" which, as noted earlier, is the major currency used by the borrower in its ordinary course of business. See *supra* note 15.

(22) CUOMO REPORT, *supra* note 13, at 44.

(23) Even if the borrower does not need to deal with a foreign currency in its ordinary course of business, it may nonetheless be affected by the movement of exchange rates if it depends on imported material for inventories, components, or raw materials that likely are subject to price fluctuations due to exchange rate movements.

(24) For example, assume lender L's functional currency is A and Borrower B's functional currency is Z. Also assume that L loans B 100 A's, secured by B's capital stock located overseas, and denominated in an equivalent amount of Z's; for example 100 Z's. If the exchange rate shifts so that it takes more Z's to buy 100 A's than at the time the loan was made, and B must repay L after liquidating its capital stock, then after L exchanges the 100 Z's for A's, it will have less than the 100 A's it originally loaned to B.

(25) A preliminary issue a lender should consider in a multicurrency financing is the allocation of currency risk; that is, whether to shift the currency risks entirely to the borrower, shoulder the currency risks by itself, or share the currency risks with the borrower. This decision will affect the financing structure, hedging devices, multicurrency provisions in the loan agreement, and the related negotiations. Generally, a right to select payment currencies by the lender at the time of payment by the borrower has the effect of transferring all or substantially all of the currency risks to the borrower. This is because the lender will demand that the loan be repaid in the currency most favorable to it based on the exchange rate effective at the time of the borrower's payment; thus, the exchange rate movements will affect only the amount of capital the borrower must have in its own functional currency in order to purchase the amount of the currency requested by the lender for repayment.

Lenders may also consider sharing currency risks with the borrower. Technically speaking, every multicurrency loan agreement has the element of risk sharing between the lender and borrower, even if the loan structure has shifted the entire currency risk to a single party, because the borrower's risks could be transferred to the lender and, to a much more limited extent, the lender's risk may also be transferred to the borrower. In most cases, express risk sharing arrangements are the result of compromises between the lender and borrower, which often result in allowing the borrower to hedge against only a percentage of the total facility, against one or two of the several credit facilities or against credit facilities in one or more of the several loan currencies.

(26) See *infra* text accompanying notes 49-106 for loan agreement provisions lenders should consider incorporating into their agreements.

(27) For a review of the current foreign exchange controls and regulations of various countries in the world, see A WORLD GUIDE TO EXCHANGE CONTROL REGULATIONS 1986/87 (P. Bentley ed. 1986); INTERNATIONAL MONETARY FUND, 1988 ANNUAL REPORT, *supra* note 13.

(28) Although devaluation mostly occurs with respect to currencies of Third World countries, major currencies are by no means immune from such practices. For instance, the dollar was devaluated twice in 1972 and in 1973. Sterling also was devaluated in the 1960s. More recently, in late 1989, Italian lira was devaluated by almost four percent against the mark. See Carrington, EMS Faces Turmoil Among Participants in Wake of Italian Devaluation of Lira, Wall St. J., Jan. 8, 1990, at C10, col. 5.

(29) "[Multicurrency] practice" includes "the existence of separate exchange rates, the application of exchange rate taxes or subsidies, . . . significant exchange rate spreads between buying and selling rates for spot transactions, and broken cross rate." INTERNATIONAL MONETARY FUND, 1988 ANNUAL REPORT, *supra* note 13, at 27. The 1982 Annual Report interprets "separate exchange rates" as "the mechanism of a dual or multiple exchange market, the establishment of separate official exchange rates for specified



transactions, or the application of exchange measures creating excessive exchange rate spreads." INTERNATIONAL MONETARY FUND, ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 1982, at 29 (1982).

(30) The Articles of Agreement of the International Monetary Fund (the Fund Agreement) do not limit the rights of its member states to restrict currency movements in the capital accounts, whereas limitations on current account transactions are generally prohibited under Article VIII, with a few exceptions. Countries that have convertible currencies also often limit convertibility to the current account items. See R. MCKINNON, MONEY IN INTERNATIONAL EXCHANGE: THE CONVERTIBLE CURRENCY SYSTEM 4-7 (1979).

(31) INTERNATIONAL MONETARY FUND ARTICLES OF AGREEMENT art. VIII, [section] 2(b). Issues relating to the enforceability of loan agreements under the Fund Agreement are discussed in detail infra notes 60-61 and accompanying text.

(32) This structure may take a variety of specific forms. It may consist of a dollar facility with a foreign currency subfacility involving some of the dollar lenders or an entirely different group of foreign currency lenders.

(33) In some cases, this problem may not be eliminated by specifying the amount of minimum assignment. For instance, if a financing has a \$200 million term loan and a \$5 million equivalent of yen revolver, limiting the minimum assignment to \$1 million equivalent of yen in one revolver could mean that each lender in this strict pro rata syndication must keep at least a \$40 million term loan.

(34) A structure restricting the borrower's ability to selectively borrow and repay will not work because its borrowing and timing needs in each currency will vary. If the facility has elements both of working capital loan (in one currency) and term loan (in another currency), the borrower's selective borrowing and repayment is almost inevitable. Even if the facility consists of two-term loans, each in a different currency, pro rata shares may still vary unless the two-term loans have the same maturity date and installment schedule. Even in such cases, the fluctuation of exchange rates may also change the pro rata shares among the lenders.

(35) Due to lenders' reluctance to depart from the principle of fundamental parity among themselves, and because of their hostilities toward any approach that has the effect of disturbing lenders' pro rata shares, issues of pro rata shares are often major factors that lead lenders to reject this structure. However, many lenders readily accept other syndicated financing structures--such as auction bid loans--that do not strictly maintain invariable pro rata shares among lenders.

(36) Issues of pro rata shares are of much less interest to the borrower. A borrower of a committed working capital facility may have an interest in preventing certain lenders with comparatively less financial strength from taking shares that are too large in order to minimize the risk of funding failure. Thus, the borrower may want to have control over the lenders' shares in the working capital commitment. However, the borrower's concern usually arises in the context of assignment and participation. This lending structure gives rise to the discrepancy between a lender's share in the commitment and its share in the outstanding loans during the life of the loan. Although it may affect lenders' relative shares, it would not increase any lender's net commitment amount without the borrower's consent, except as a result of assignment and participation, as in any other syndicated loan.

(37) It is important to clarify the concept of "commitment" with respect to term loans. Some loan agreements refer to the term loan commitment as terminated after closing or after the period during which borrowing of term loans is permitted. Some other agreements, however, consider the term loan commitment remaining even though the borrower may not borrow after closing or after a specified period following the closing. Thereafter, the term loan commitments shall equal the total outstanding term loans as may be reduced from time to time by the borrower's repayments. "Commitment pro rata shares," referred to throughout this article, is based on this latter definition of "term loan commitment."

(38) Pro rata problems are most likely to arise in a working capital loan or a facility with a working capital loan component. In such cases, the borrower's nonratable prepayments and borrowing may affect the lender's pro rata shares, but the borrower may also nonratably reduce or terminate

different currency facilities. If the credit facility has only term loans, all funded on the closing date, there could be similar problems, but to a much lesser extent.

(39) Assignment may also change the assignee-lender's relative share, but would not disturb the other lenders' relative shares.

(40) On the closing date, the lead of a syndication may underwrite a substantial portion of the total facility and therefore have a pro rata share close to or in excess of the 50% requisite voting power. In such a case, a lender may have a significant interest in insisting on certain pro rata shares most beneficial to it so that changes in the borrower's practice would not affect its voting power.

(41) With respect to fees that are not shared by lenders, such as agent fees and fees paid upon delivery of the lender's commitment letter, changes in pro rata shares among lenders will not give rise to problems.

(42) In many transactions, up-front fees are divided among the lenders under separate fee sharing arrangements outside the framework established by the loan agreement, which may or may not reflect the lenders' relative shares in the total loans or commitments.

(43) For example, a foreign currency subfacility lender holding 10% of the total facility on the closing date may find itself holding 60% of the total outstanding loans if the borrower has prepaid most of the loans denominated in other currencies.

(44) For instance, the loan agreement may contain financial covenants that require the borrower to apply its cash, whether derived from sales of assets or inventory, first to the outstanding loans denominated in the same currency. Lenders also may consider introducing a financial covenant preventing the borrower, without the lenders' consents, from departing from its established business practices, for example, using sterling to bill a Japanese buyer for goods produced by the borrower in the United States, for which the borrower customarily receives yen. This practice would allow the borrower to first pay down the sterling loan instead of the yen loan.

(45) The lender's repurchase obligation is functionally equivalent to a guaranty since such lender in fact underwrites the borrower's credit risk for the benefit of another lender. Although early case law suggests that issuance of a third party guaranty is beyond a national bank's power under 12 U.S.C. [section] 24, see OCC Staff Issues Opinion on Draft Authorization Agreement by National Banks, Fed. Banking L. Rep. (CCH) [paragraph] 85,295 (Sept. 25, 1981), the recent trend represented by 12 C.F.R. [subsection] 7.7000 to 7.7016 indicates that a financial arrangement by a national bank which functionally resembles a guaranty is not per se illegal. The key issue is how to draft and structure such "put" arrangements. Many loan agreements in the market have provisions on ratable sharing and sharing of setoffs, which are similar in nature to such "puts," and which apparently have been accepted by the banking regulatory authorities.

(46) This will work if the adjustment is made at the time the revolver is paid down. Many working capital loans do require the borrowers to pay down the loans periodically. If there are revolving loans outstanding, a complete adjustment can be made only if Bank A purchases a participation from Bank B.

(47) Suppose, in the above example, that in addition to the dollar and sterling subfacilities lent by Bank A and Bank B, there is an additional yen term loan subfacility of \$20 million equivalent that is entirely lent by a third lender, Bank C, and therefore the pro rata shares on the closing date are: 37.5% for Bank A; 12.5% for Bank B; and 50% for Bank C. Upon the payment by the borrower of \$5 million under Bank A's dollar term loan, as stated in the above example, lenders' pro rata shares will be: 29% for Bank A; 14% for Bank B; and 57% for Bank C. To bring the pro rata shares back to the initial 37.5%-12.5%, Bank A must purchase a participation from Bank B in sterling and Bank C in yen. This will frustrate the very purpose of this currency oriented lending structure, which is to allow Bank A to participate in the lending as a dollar and sterling lender without exposing itself to the currency risk involved in the yen loan.

(48) Certain carefully crafted and limited adjustments may not necessarily complicate the syndication. Suppose Bank A in the above example sold out all of its loans and commitments to two lenders, Bank D and Bank E, 50% each. Then Bank A's right to sell and obligation to buy participation under this limited adjustment mechanism will be shared

ratably by Bank D and Bank E.

(49) "Currency equivalent" is often expressed as "Yen Equivalent," "Dollar Equivalent," or "Sterling Equivalent," etc. In a multibillion dollar acquisition financing, "Yen Equivalent" is generally defined as "at any time for the determination thereof the amount of yen obtained by converting the U.S. dollar amount involved in such computation into yen at the average buy and sell rate of yen with U.S. dollars" as quoted by Telegrade Page 209 (or such other page or pages that replace such page) at approximately 11:00 a.m. (New York time).

(50) Exchange rates also are determined on the basis of the rates displayed on the Reuter screen. The Reuter screen, in fact, also reflects the rates offered by major money-center banks, so-called "market makers." Due to the highly liquid nature of the currency market, the rates offered by major banks are substantially similar at any given time.

(51) The spread between buying and selling rates is not normally a significant percentage. The spread fluctuates, however, as the exchange rates become volatile because the spread in part reflects the traders' capital cost and cost for self-insurance in trading certain currencies. As a result, the spread can be substantial. See, e.g., *infra* note 53.

(52) During any trading day, exchange rate swings of about 10% are common. For \$100 million worth of any foreign currency, a 1% change in the exchange rate means \$1,000,000 of loss or gain. An extreme example of this occurred on November 1, 1978, when the dollar rose by an average of 7% against yen and mark within a few hours after the trading started. See C. TYGIER, *BASIC HANDBOOK OF FOREIGN EXCHANGE, A GUIDE TO FOREIGN EXCHANGE DEALING* 86 (2d ed. 1988).

(53) If the rate effective on Friday is favorable to the borrower, the borrower could argue that the dollar value of the yen loan should be ascertained at the time it is due, not when it is paid or should have been paid. Although the rate effective on Friday is not the rate effective on Saturday, when the loan is due, the Friday rate shall apply until a new rate appears on Monday. The borrower may even find support from the U.S. Code, which states that "when merchandise is exported on a day that banks are generally closed in New York, the buying rate at noon on the last prior business day is deemed to be the buying rate at noon on the day the merchandise is exported." 31 U.S.C. [section] 5151(a)(2) (1988). At a minimum, the average of the Friday and Monday rates should apply instead of the Monday rate, as suggested by the lender. The lender may argue that until the payment is made, the determination of the currency equivalent or exchange rate does not come into play, and therefore the rate in effect on Monday should apply. The lender's argument, however, could be weakened by the rule of interpretation that unclear provisions should be interpreted against the party preparing the document.

(54) "In the New York foreign exchange market, immediate delivery is one business day for exchanges between North American currencies . . . and two business days otherwise." Levich, *Exchange Rates and Currency Exposure*, in *HANDBOOK OF FINANCIAL MARKETS AND INSTITUTIONS* 18.3, 18.4 (E. Atman 6th ed. 1987).

(55) "Banks can even trade for 'cash,' whereby the transaction is agreed and payment is made all on the same day." R. KUBARYCH, *FOREIGN EXCHANGE MARKETS IN THE UNITED STATES* 9 (rev. ed. 1983). However, because of time zone differences, interbank cash transactions are rare for U.S. banks. See *id.* When such cash trades do take place, the exchange rates are likely to be similar to the rates in clause (3).

(56) This is similar to the determination of interest rates for Eurocurrency borrowing. Banks normally fix the interest rates two days prior to the beginning of an interest period, instead of the first day of such period because the banks' lending costs--that is, the interest rate offered to the banks to be applied on the first day of the interest period--are fixed two banking days prior to the first day of the interest period.

(57) The standard loan agreement of the World Bank generally allows the borrowers to draw in "the respective currencies" in which the borrowers finance their projects. See *INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, GENERAL CONDITIONS APPLICABLE TO LOAN AND GUARANTEE AGREEMENTS* art. IV, § 4.01 (1985). In practice, however, borrowers are rarely given such flexibility.

(58) Generally a currency is "convertible" if it can be freely bought or sold without restrictions. There can be restrictions as to the amount

converted, the purpose of conversion, and so on. Such restrictions could affect the lender's interest. As a result, the lender's right to determine "convertibility" is important.

(59) A broadly worded "change of circumstances" clause normally covers the convertibility issue.

(60) Many countries limit the convertibility of their currencies to transactions of current account. Current transactions are defined as "payments due as interest on loans and as net income from other investments," as well as "payments of moderate amount for amortization of loans or for depreciation of direct investments." INTERNATIONAL MONETARY FUND ARTICLES OF AGREEMENT art. XXX(d)(2), (3).

(61) A member state of the IMF may not "without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." Id. art. VIII, [section] 2(a). As of March 31, 1989, 65 countries had accepted the obligations under Article VIII. However, the remaining "86 member countries--all developing countries--avail themselves of Article XIV [of the Fund Agreement] status" that permits members to "maintain those exchange restrictions in effect at the time" they joined the IMF. See INTERNATIONAL MONETARY FUND, DEVELOPMENTS IN INTERNATIONAL EXCHANGE AND TRADE SYSTEMS 3 (1989).

(62) Insolvency or bankruptcy of the counterparty to a currency risk protection agreement could eliminate the value and protection the borrower bargained for in such an agreement. See Henderson, Credit Risk and Swap Exposure, in SWAP FINANCING TECHNIQUES (B. Antl ed. 1983). A lender could avoid the counterparty insolvency problem by requesting that the borrower enter into a currency protection agreement with itself or members of the syndications.

(63) For a detailed discussion on such exposure, see *supra* notes 17-21 and accompanying text.

(64) See *infra* note 66 and accompanying text.

(65) Such increase in funding cost may not be adequately covered by the standard "yield protection clause," which is often premised on the change in the applicable laws or regulations.

(66) See, e.g., 12 C.F.R. [section] 208 apps. A(IV)(A), (B) (1990); id. [section] 225 apps. A, B (1990). The Guidelines include both a definition of qualifying capital for the risk-based capital ratio, and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. "A bank's risk-based capital ratio is calculated by dividing its qualifying capital . . . by its weighted risk assets. . . ." Id. [section] 208 app. A(I). The Guidelines also provide for transitional arrangements during a phase-in period to facilitate their implementation at the end of 1992. See id. [section] 208 app. A(IV)(B). Other federal banking agencies, including the Office of the Comptroller of the Currency, have enacted substantially identical guidelines. For a review of the impact of these guidelines on the current banking practice, see Malloy, U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected, 7 ANN. REV. OF BANKING L. 75 (1988).

(67) 12 C.F.R. [section] 208 app. A(III)(C) (1990).

(68) For example, such loans include loans to central government of OECD countries and countries that have concluded special arrangements with the IMF under in General Arrangements to Borrow. "The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabi has concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow." Id. [section] 208 app. A n.22.

(69) Id. [section] 208 app. A(III)(C)(1).

(70) Id. [section] 208 app. A(III)(C)(4). However, if such loans are made in local currencies and the lender has liabilities booked in that currency, then the assets are categorized as "zero risk." Id. app. A(III)(C)(1).

(71) Id. app. A(III)(C)(2). Such loans are categorized as "20% risk" assets, as opposed to the "100% risk" label they would have without such guarantees. This category also includes loans guaranteed by a U.S. government sponsored agency such as the Federal Home Loan Mortgage

Corporation or Student Loan Marketing Association.

(72) LIBOR is the London Interbank Offer Rate, and is the key interest rate used in the Eurocurrency market. Logue, *supra* note 3, at 13.12.

(73) See *supra* note 50.

(74) Other similar foreign currency-related intercompany practices include intercompany reinvoicing and intercompany factoring, which places the currency risk with the factoring entity by requiring the factoring company to pay in the functional or local currency of the manufacturing company, even though the receivables are denominated in a different currency.

(75) See Meierjohann, *The Issue of Organizational Structure III*, in *MANAGEMENT OF FOREIGN EXCHANGE RISK*, *supra* note 8, at 238.

(76) A borrower may find maintaining the foreign exchange current ratio burdensome because its consolidated financial statements, prepared under Generally Accepted Accounting Principles (GAAP), will not show the currency of the current assets or liabilities. Under the GAAP, a consolidated financial statement will use a reporting currency that normally is the functional currency of the parent company. In addition, all accounting items of its foreign subsidiary, if denominated in a foreign currency, should be translated into the reporting currency in accordance with the rules set forth in the Financial Accounting Standards Board's Statement No. 52 on Foreign Currency Translation (F.A.S. No. 52), which was introduced in the United States in December 1981. See *BUSINESS INT'L CORP., NEW DIRECTIONS IN MANAGEMENT CURRENCY RISK: CHANGING CORPORATE STRATEGIES AND SYSTEMS UNDER F.A.S NO. 52* (1982). This means that unless it has a centralized currency risk management system, a U.S. multinational borrower may have to establish a system to monitor its current accounts in major foreign currencies on a global basis in order to fulfill its obligations under the financial covenant. However, if the currency risk indeed appears significant in light of the borrower's financial strength, and poses major concern to the lender, it is not unreasonable for the lender to request that the borrower institute a system that, under such circumstances, should be part of prudent management practice.

(77) For a different structure which may help minimize such syndication difficulties, see *supra* text accompanying notes 32-48.

(78) It has been noted that in the interbank market, banks rarely deal with foreign currency for less than the equivalent of one million dollars per transaction. The normal transaction size in major currencies in a normal market environment in the 1980s was five million dollars. C. TYGIER, *supra* note 52, at 46. Except for large money-center banks, U.S. lenders of foreign currencies do not have the flexibility, as when dealing with dollars, to adjust their funding needs on a broad basis and to accommodate borrowing of small amounts.

(79) See, e.g., *INTERNATIONAL DEVELOPMENT ASSOCIATION, GENERAL CONDITIONS APPLICABLE TO DEVELOPMENT CREDIT AGREEMENTS* [section] 4.02 (1985), under which the borrower, so long as it meets certain requirements, may select the repayment currency from among "eligible currencies."

(80) For instance, a U.S. company's U.K. subsidiary that needs a dollar working capital loan to finance the cost of inventory purchased in the United States may want to have the option to repay the loan in sterling, because most of its sales are made for sterling within the United Kingdom. In a standard receivable financing, however, a U.S. bank normally considers the receivables generated overseas ineligible as collateral.

(81) In fact, such multiple-currency clauses in borrower's favor are rarely seen in the market.

(82) E.g., *INTERNATIONAL DEVELOPMENT ASSOCIATION*, *supra* note 79, [section] 4.03 provides: "The principal amount of the Credit repayable shall be the equivalent (determined as of the date, or the respective dates, of repayment) of the value of the currency or currencies withdrawn from the Credit Account. . . ."

(83) Under some multiple-currency clauses, the exchange rate effective when the payment is due or made determines the amount of repayment. This approach does not protect lenders from the decrease in the loan value as a result of the loan currency's depreciation or devaluation. It does make it possible for the lenders to get paid in a different currency when payment by the borrower in the loan currency becomes illegal. The lenders also may consider requiring the borrower to give them the

option to determine the place of payment so that when the payment in one place becomes illegal, the lenders could nonetheless get paid in a different place. For a detailed analysis of these alternative multiple-currency clauses, see Kransnostein, *The Use of Multi-Currency and Multi-International Jurisdiction Stability Agreements Under Article VIII(2)(b) of the International Monetary Fund Articles of Agreement*, 12 SYR. J. INT'L L. & COM. 15, 20-25 (1985).

(84) See *Miliangos v. Frank Ltd.*, 1976 App. Cas. 443, 444 (H.L. 1975).

(85) The New York state courts are a significant exception. Under an amendment to New York law, effective July 20, 1987, "[i]n any case in which the cause of action is based upon an obligation denominated in a currency other than currency of the United States," the New York courts are required to "render or enter a judgment or decree in the foreign currency of the underlying obligation." N.Y. JUD. LAW [section] 27(b) (McKinney Supp. 1990). See also *infra* note 91 and accompanying text.

(86) But see U.C.C. [section] 3-107, which apparently provides the basis for U.S. courts to issue judgments in foreign currency on instruments payable in foreign currency. The relevant part of the section reads: "If such an instrument specifies a foreign currency as the medium of payment the instrument is payable in that currency." U.C.C. [section] 3-107(2) (1972). Although Official Comment 4 to [section] 3-107 provides that it is presumed that "the obligation may be satisfied by payment in dollars," it notes that if "the instrument otherwise specifies," it must be payable in the specified foreign currency, and therefore a judgment may be entered into thereon. However, [section] 3-107 has only limited application, for some states have not adopted the language relating to foreign currencies. Furthermore, notes used in most syndicated loans are nonnegotiable within the meaning of U.C.C. Article 3 and therefore are not governed by Article 3. See, e.g., *Henry v. Cobb Bank & Trust Co.*, 151 Ga. App. 725, 726, 261 S.E.2d 459, 460 (1979), *rev'd on other grounds*, 246 Ga. 225, 271 S.E.2d 444 (1980).

(87) Bar Association of the City of New York, *Foreign Currency Judgments: 1985 Report of the Committee on Foreign and Comparative Law*, 18 N.Y.U. J. INT'L L. & POL. 791, 791 (1986) [hereinafter 1985 Report].

(88) 22 AM. JUR. 2D Damages [section] 85 (1988). See also 1985 Report, *supra* note 87, at 792-93.

(89) U.C.C. [section] 3-107 comment 4 (1972).

(90) Because the calculation of damages is an issue of substantive law, a federal court sitting in diversity must adhere to the doctrine of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), and apply the conversion formula employed by the courts in the jurisdiction where the action is brought. *Competex, S.A. v. Labow*, 783 F.2d 333, 334 (2d Cir. 1986); *Vishipco Line v. Chase Manhattan Bank, N.A.*, 660 F.2d 854, 865 (2d Cir. 1981), *cert. denied*, 459 U.S. 976 (1982). On the other hand, in determining which rule to apply in nondiversity cases, the weight of federal authority looks to two Supreme Court cases for guidance: *Hicks v. Guinness*, 269 U.S. 71 (1925), and *Deutsche Bank Filiale Nurnberg v. Humphrey*, 272 U.S. 571 (1926). In *re Good Hope Chemical Corp.*, 747 F.2d 806, 809-11 (1st Cir. 1984); *Jamaica Nutrition Holdings v. United Shipping Co.*, 643 F.2d 376, 380 (5th Cir. 1981). The approach prescribed by these two decisions is dependent upon the jurisdiction in which the cause of action arose.

(91) For example, a New York statute expressly requires the conversion of a judgment, denominated in a foreign currency into U.S. dollars "at the rate of exchange prevailing on the date of entry of the judgment or decree." N.Y. JUD. LAW [section] 27(b) (McKinney Supp. 1990). See also *supra* note 85 and accompanying text.

(92) *Pecaflor Constr. Inc. v. Landes*, 198 Cal. App. 3d 342, 346, 243 Cal. Rptr. 605, 607 (1988) (quoting *Levi Strauss & Co. v. Aetna Casualty & Sur. Co.*, 184 Cal. App. 3d 1479, 1487, 237 Cal. Rptr. 473, 478 (1986); *Good Hope Chem.*, 747 F.2d at 810-12. According to the court in *Pecaflor*, the California cases are "generally consistent with federal Supreme Court precedent that makes the choice of the breach-day or judgment-day rule depend on the jurisdiction in which the plaintiff's cause of action (or the defendant's obligation) arose." *Pecaflor*, 198 Cal. App. 3d at 346, 243 Cal. Rptr. at 607.

Under the Supreme Court's approach, when the action arises entirely under foreign law, the judgment-day rule applies because the parties have

assumed the risk of currency fluctuations in basing the contract on a foreign currency. *Good Hope Chem.*, 747 F.2d at 811; *Jamaica Nutrition*, 643 F.2d at 380. However, if the plaintiff has a cause of action in the United States at the time of the default, the breach-day rule applies. This view is based on the fact that the plaintiff had a claim for U.S. dollars at the time its cause of action arose, and can thus be made whole by awarding it its expectancy as of the date its loss occurred. *Good Hope Chem.*, 747 F.2d at 811; *Jamaica Nutrition*, 643 F.2d at 380; *Levi Strauss*, 184 Cal. App. 3d at 1488, 237 Cal. Rptr. at 478. As Justice Holmes noted, "[a]n obligation in terms of the currency of a country takes the risk of currency fluctuation and whether creditor or debtor profits by the change the law takes no account of it." *Deutsche Bank*, 272 U.S. at 519.

This approach is consistent with RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971), which applies the judgment-day rule if the cause of action is governed by foreign law, stating in part that "[t]he amount of recovery in damages should not vary with the state where suit happens to be brought." American courts "should seek to give a judgment for damages that is equivalent in value to that which would have been rendered by the courts of that nation." *Id.* [section] 144 comment b.

(93) Any interest loss the lender incurs is to be compensated either under the post-default rates normally provided in loan agreements or under the judgment rate provided in the applicable law.

(94) Whether such a lender may recover as damages the difference between its foreign currency liabilities and the foreign currency it can purchase with its U.S. dollar recovery is unclear, at least if the loan documents do not indicate that such a loss to the lender is payable by the borrower.

(95) Although the objective of the breach-day rule is to restore the plaintiff to the position it would have occupied had the defendant not defaulted on its obligation, this rule may not fully compensate a party when the foreign currency has appreciated in relation to the dollar. Similarly, the breach-day rule may also play into the hands of unscrupulous borrowers who, anticipating a revaluation of the loan currency, intentionally default in order to capitalize on the favorable exchange rate. However, "[t]he gamesmanship of the breach-day rule can be avoided by selecting a conversion rule of general application that is neutral between the parties with respect to currency fluctuation." *Competex*, 783 F.2d at 337.

The payment-day rule is "economically equivalent" to awarding a judgment in the foreign currency. *Id.* at 338. However, because of concern that a judgment be entered for a fixed sum of dollars, the payment-day rule has rarely been applied in the United States. *Id.* Such courts consider a clearly defined rule, rather than a more flexible approach, to be of great importance in commercial transactions. See *Levi Strauss*, 184 Cal. App. 3d at 1488, 237 Cal. Rptr. at 478.

(96) The date of default "marks the essential event which gives rise to the cause of action and bears a necessary relation to the wrong sought to be redressed." *Deutsche Bank*, 272 U.S. at 523 (Sutherland, J., dissenting). However, the judgment-day rule "bears no [such] relation whatever to the wrong complained of," nor to the cause of action. *Id.* "To take the date of judgment for determining the value is to adopt for the measurement of a loss a test resting upon the fluctuating chances of a court calendar instead of upon an event already fixed,--that is, to put aside certainly for uncertainty." *Id.* The judgment-day rule is incapable of universal application because the amount of recovery depends upon the vicissitudes of whether the suit is timely brought, whether the defendant engages in stalling tactics, the speed of the court's docket, and whether there is a successful appeal and a new trial. Under these circumstances, the sum ultimately recovered by the plaintiff "may be altogether insignificant." *Id.* at 525.

(97) See, e.g., RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES [section] 823(2) (1987).

(98) See *id.*; *Competex*, 783 F.2d at 336 (applying the breach-day rule and noting an extreme rule of creditor preference that enables lenders to benefit from currency fluctuations, although neither party should receive a windfall as a result of currency conversion); *Newmont Mines Ltd. v. Adriatic Ins. Co.*, 609 F. Supp. 295, 297 (S.D.N.Y. 1985), *aff'd sub nom. Newmont Mines Ltd. v. Hanover Ins. Co.*, 784 F.2d 127 (2d Cir. 1986)

(applying the breach-day rule and stating that a debtor should not benefit from its failure to pay a debt on time). But see Pecaflor, 198 Cal. App. 3d at 349, 243 Cal. Rptr. at 609 (noting but not following, the Restatement rule that would allow a creditor to choose between the values of two currencies in an action for enforcement of a foreign judgment, because the court claimed that this rule "would promote forum shopping").

(99) RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES [section] 823 comment d (1987).

(100) Id. [section] 823(2).

(101) United Nations Convention on International Bills of Exchange and International Promissory Notes, approved Dec. 9, 1988, reprinted in 28 I.L.M. 170 (1989) [hereinafter Convention]. Under Article 89, it will become effective "on the first day of the month following the expiration of twelve months after the date of deposit of the tenth instrument of ratification, acceptance, approval or accession." Like the United Nations Convention on International Sales of Goods, the Convention applies only to international negotiable instruments and only if parties choose it as governing law.

Under the Convention, the exchange rate used to determine an amount payable is the rate specified in the instrument. Absent such specification, the holder of the instrument may choose between (1) the rate effective when the instrument is dishonored, if the instrument is dishonored by nonacceptance, or the rate effective when payment is due, if the instrument is dishonored by nonpayment, and (2) the rate effective when the payment is actually made. The Convention also gives the courts the power to award "damages for loss caused to the holder by reason of fluctuations in rates of exchange if such loss is caused by dishonour for non-acceptance or by non-payment." Id. art. 75(3), (4).

(102) Although the Convention defines promissory note more broadly than UCC Article 3, interpreted by many U.S. courts to include notes with variable interest rates or denominated in composite currencies, it nonetheless requires one essential element: "an unconditional promise whereby the maker undertakes to pay a definite sum of money to the payer or to his order." Id. art. 3(2)(a); see also U.C.C. [section] 3-104(7) (1972) (stating the requirements for being a negotiable instrument). Because most promissory notes issued in connection with financing provide that "this note is subject to and issued in accordance with that certain credit agreement," or language to similar effect, the Convention would not apply to these notes.

(103) The judgment currency provision, under some credit agreements, provides that the amount of a lender's recovery is determined on the basis of the exchange rate in effect on the day following the day when the lenders receive the payment, instead of the rate effective on the payment day.

(104) "Separate and independent" is intended to prevent the courts from merging the borrower's obligations into the judgment.

(105) "The breach-day rule protects the judgment creditor against fluctuation in currency values to the point of allowing him to speculate without risk." *Competex*, 783 F.2d at 339.

(106) An alternative currency clause might provide that if the borrower fails to pay on the due date, the lender has the option to purchase the judgment currency with the loan currency. Like the currency clause discussed earlier, however, this clause may work well for some lenders, but not for others.

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